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No. _____

IN THE

Supreme Court of the United States

OCTOBER TERM 1982

ROBERT M. RAPAPORT,

Petitioner,

—v.—

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

FREDERICK T. DAVIS

Attorney for Robert M. Rapaport
30 Rockefeller Plaza
New York, New York 10112
(212) 541-4000

Of Counsel:

Leslie C. Levin

Patterson, Belknap, Webb & Tyler
30 Rockefeller Plaza
New York, New York 10112
(212) 541-4000

QUESTIONS PRESENTED

1. In a federal criminal tax prosecution where the substantive tax law at the time of the events was unclear and the principal defense was lack of willfulness, was it error to refuse to instruct the jury that it could consider the uncertainty of the governing regulations and rulings as bearing on the determination of willfulness? The Fifth and Ninth Circuits have previously answered in the affirmative; the Second Circuit in this case answered in the negative.

2. In a federal criminal tax prosecution where the substantive tax law at the time of the events was unclear and the principal defense was lack of willfulness, was it error to exclude competent proof that the substantive tax law was, in fact, unclear? The Fifth and Ninth Circuits have previously answered in the affirmative; the Second Circuit in this case answered in the negative.

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Robert M. Rapaport respectfully requests that a writ of certiorari issue to review the opinion and judgment of the United States Court of Appeals for the Second Circuit entered on January 5, 1983.

OPINION BELOW

The opinion of the Court of Appeals has not been officially reported. It appears in the Appendix hereto at A-1–A-26.[1]

The District Court filed no opinions on issues raised in this petition.

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1 Citations to the Appendix to this petition are in the above form. The trial transcript is cited as "Tr."

JURISDICTION

The judgment of the Court of Appeals was entered on January 5, 1983 (A-27–A-28). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTE INVOLVED

This case involves a prosecution under 18 U.S.C. § 371 and 26 U.S.C. §§ 7201 and 7206(2). The text of those statutes appears in the Appendix at A-29.

STATEMENT OF THE CASE

A. Introduction.

This Court should review the decision of the Court of Appeals for three compelling reasons.

—*The Court of Appeals reached an illogical result:* Acknowledging that the element of willfulness in tax prosecutions requires proof of an "intentional violation of a *known* legal duty," and in the face of an overwhelming demonstration that the tax law that the defendants are accused of having "known" was uncertain and thus unknowable, the panel nonetheless held that this uncertainty was irrelevant to the jury's determination of willfulness, approved the refusal to charge the jury that it could consider the status of the tax law in assessing willfulness, and upheld the exclusion of competent evidence on this point.

—*The Court of Appeals has created a conflict in the circuits:* In reaching its illogical conclusion, the panel expressly acknowledged that it "declined to follow" decisions of the Fifth Circuit (*en banc*) and of the Ninth Circuit mandating the opposite result.

—*The Court of Appeals incorrectly decided an issue of fundamental importance in federal tax prosecutions:* The Government frequently initiates tax evasion prosecutions where, as here, the substantive tax law is subject to dispute. The question of the appropriate standards governing the jury's determination of willfulness in such prosecutions is extremely important and will arise frequently.

In sum, the panel in this case reached an unprecedented and illogical result on an issue of great practical significance, and in the process rejected the law of two other circuits. This Court should review the conflict. Supreme Court Rule 17.1(a).

B. The Facts.

At relevant times, Robert M. Rapaport ("Rapaport") was the President of SuCrest Corporation, now known as Ingredient Technology Corporation. SuCrest was then in the business of buying, refining and selling sugar in wholesale lots. The Government charged that Rapaport and SuCrest[2] engaged in a scheme to evade SuCrest's corporate taxes by the improper inclusion of certain sugar purchases in its inventory, as follows.

Due to dramatic increases in the price of domestic raw sugar in 1974, SuCrest shifted, on the recommendation of accountants, from a FIFO ("First In First Out") to LIFO ("Last In First Out") inventory accounting method. Under the LIFO method, inventories are valued at the price of the earliest purchases, and the cost of goods sold is valued at the price of the latest purchases (Tr. 514). In this way, the LIFO method matches current costs against current revenues (Tr. 671, 672-673).

Toward the end of its fiscal year 1975, SuCrest discovered that its inventory of sugar had fallen to historically low levels. Since this was a period of rapid inflation in sugar prices, the

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2 Also charged in the indictment was Allerton D. Marshall, the Treasurer of SuCrest. He was acquitted at trial.

low inventory level meant that the company would "invade" its LIFO inventory base, and measure its revenues against the cost basis of "old" (and therefore cheap) sugar, instead of against "current" (and therefore relatively expensive) sugar.[3] Recognition of profit on this distorted basis would have artificially exaggerated the profits, and therefore the taxes, of SuCrest, defeating the purpose of the LIFO election.

In order to avoid this result, SuCrest adopted the following procedure: Shortly before the end of its 1975 fiscal year, SuCrest entered into a written agreement with one of its suppliers, Czarnikow-Rionda Co. ("Rionda"), to purchase sufficient quantities of sugar to buffer its LIFO base. Simultaneously with this agreement, the parties reached an oral understanding that early in the 1976 fiscal year Rionda would repurchase a similar amount of sugar based upon market prices at that time. At the time of the original purchase, both Rionda and SuCrest entered into opposite transactions on the futures exchange, thus "hedging" their purchases.[4]

Shortly after the written agreement was entered into with Rionda, a Rionda official requested from a SuCrest employee

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3 The essence of both FIFO and LIFO inventory theories, of course, is that both are equally abstract; in neither instance does the priority in which the commodity is recognized for costing purposes follow the actual movement of real sugar.

4 The same result could have been achieved, in a manner that the Government apparently concedes to be beyond reproach, if SuCrest had purchased the Rionda sugar for delivery during the 1975 fiscal year and simultaneously sold the same amount of sugar short on the New York Coffee and Sugar Exchange ("the Exchange") for delivery after the end of the fiscal year—a traditional "hedge." The shortcoming of such a hedge, however, was that the price of actual sugar is a CIF ("cost, insurance and freight") quotation, while prices on the Exchange are FOB ("free on board") prices. The difference between these prices—the so-called "CIF differential"—varies widely and is itself subject to market fluctuation; SuCrest had recently lost approximately $2.5 million, in a period of a few months, because of fluctuations in the CIF differential (Tr. 703, 1663). The "double hedge" accomplished through Rionda, in essence, allowed SuCrest to hedge both the purchase of the Rionda sugar and the CIF differential.

a letter confirming the understanding that SuCrest would resell a similar amount of sugar in the new fiscal year, and such a letter was thereafter delivered to Rionda. There was no evidence suggesting that Mr. Rapaport knew of the existence or content of this letter; indeed, Mr. Rapaport told SuCrest employees not to enter into a written re-sale agreement. Before the end of the fiscal year 1975, Rionda declared to SuCrest the sugar cargoes of two ships, thereby passing title and risk of loss of the sugar to SuCrest in accordance with the terms of the written contract (Tr. 865-866, 1297). When SuCrest filed its tax return for 1975, it calculated its profits based upon the inclusion of the Rionda sugar inventory.

Toward the end of its 1976 fiscal year, SuCrest and Rionda engaged in a similar series of transactions. Once again, Rionda sold and declared to SuCrest a large quantity of sugar at the end of the fiscal year, and in the early weeks of the new fiscal year SuCrest sold to Rionda a corresponding amount of sugar, by prior arrangement. With respect to its 1976 corporate tax returns, however, SuCrest did not include the Rionda purchases in its inventory. This change in tax treatment was the result of an internal investigation conducted at SuCrest's request by the New York law firm of Milbank, Tweed, Hadley & McCloy. After a lengthy investigation that included the taking of sworn testimony, the Milbank firm issued a report concluding that the Rionda sugar should not be included in SuCrest's inventory for tax purposes, but observed that its conclusion was "not free from dispute, and reasonable persons expert in the fields of tax law and accountancy may differ in their interpretations and conclusions." I.T.C. Pre-Trial Reply Memo at 3.[5]

The net result of the 1975 Rionda transactions—and the contemplated result of the 1976 transactions as well—was the postponement of corporate taxes. The temporary addition of the Rionda sugar to inventory did not eliminate the ultimate

5 The Milbank report was not admitted into evidence before the jury. It was, however, before the trial court on legal motions addressed to the uncertainty of the tax laws.

need to recognize profits calculated on the basis of the "old" (and thus inexpensive) sugar; it merely postponed such recognition into a later year. As a matter of logic, profit based on the inventory would eventually have to be recognized; in fact, SuCrest recognized such profits—and thus paid every penny of taxes that it was alleged to have "avoided" in 1975—when it closed out its sugar inventory.

As set forth at pp. 7-8 below, the tax issue of whether SuCrest could include the Rionda purchases in inventory had never, prior to this case, been litigated in any civil or criminal proceeding, nor was it addressed by any tax regulation or ruling until 1979—several years *after* the events in question—when the Internal Revenue Service adopted Rev. Rul. 79-188, 1979-1 C.B. 191, which stated its position on the issue for the first time. The use of commodity transactions for the sole purpose of postponing the recognition of profit, of course, is not new, and has been expressly tolerated by the Internal Revenue Service.

For example, "tax straddles" were until recently legitimate means to accomplish deferral of tax payment from one year to the next. *United States v. Winograd,* 656 F.2d 279, 281 (7th Cir. 1981), *cert. denied,* 102 S.Ct. 2257 (1982).[6] The deferral was accomplished by going "long," or being a buyer of a commodity in one future month and going "short," or being a seller of the same commodity in another month. When the prices of the futures contracts changed, one account would show a loss while the other would show the corresponding gain. The key to the transaction was to liquidate the losing account, or "leg," during the first tax year and to liquidate the gain-bearing account or "leg" in the following tax year. The legs were then usually immediately reestablished for future

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6 Although the conviction in *Winograd* was affirmed, the court relied on the facts that the defendants fraudulently manipulated the commodity prices, which were not executed within the relevant day's market price range, and that their activities were in clear violation of the applicable commodity trading laws.

months, thus "rolling-over" the transaction. If all went as expected, the losses would nearly or exactly equal the gains and there would thus be no real economic impact on the investor. Beneficial tax treatment would result, however, when "losses" sheltered other unrelated income. *Id.* In short, straddles performed exactly the same function as the Rionda purchases—the postponement of taxes to a later tax year through commodity purchases—and were expressly tolerated by the I.R.S. until the practice was administratively disapproved.[7]

C. The Trial.

Other than this case, there has *never* been a criminal or civil determination of the propriety of including in LIFO inventory a commodity purchased subject to a resale understanding. The defendants argued that the Rionda transactions met all indicia for inventory as set forth in the Code and the tax regulations, which define inventory as raw materials purchased for sale and to which the taxpayer has title. 26 C.F.R. § 1.471-1. As the evidence revealed, SuCrest had acquired the sugar for sale and had title[8] as well as risk of economic and physical loss. Moreover, numerous cases held that passage of title was the key factor in determining whether the goods are includible in

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7 It was not until 1977 that the Internal Revenue Service indicated that losses generated by silver straddles were not deductible under the Code where the taxpayer continued a balanced position in silver contracts by closing out his losing position and immediately purchasing new contracts for delivery in the next tax year. Rev. Rul. 77-185, 1977-1 C.B. 48. This ruling was greeted with considerable surprise by the tax community and represented a complete turnabout in the law. *See, e.g.*, 77 Tax Advisor 535-36 (1977) (discussing change in "long-standing and well known tax practice"). Other types of complex commodity tax straddles, designed only to have pre-arranged tax consequences and not to generate income, have only recently been limited by the Tax Court. *See, e.g., Smith* v. *Commissioner*, 78 T.C. 350 (1982).

8 Indeed, the Government conceded that SuCrest had title to the sugar at the end of its fiscal year (Gov't Pre-Trial Memo of Law, p. 22).

closing inventory[9] and revealed that in other analogous areas of tax law, courts apply the "passage of title" test or look for similar literal compliance with the requirements of the Code rather than engaging in analysis under the unpredictable "substance over form" doctrine. *See, e.g., United States* v. *Balonovski*, 236 F.2d 298, 306 (2d Cir. 1956), *cert. denied*, 352 U.S. 968 (1957). *See also Comm'r* v. *Pfaudler Inter-American Corp.*, 330 F.2d 471, 474 (2d Cir. 1964); *Barber-Greene Americas, Inc.*, 35 T.C. 365, 386 (1960), *acq.* 1964-2 C.B. 4; *Otis Elevator Co.* v. *United States*, 618 F.2d 712, 727 (Ct. Cl. 1980). By contrast, the Government did not, and could not, point to any portion of the Internal Revenue Code or the Treasury Department Regulations that prohibited or limited SuCrest's conduct. Rather, it argued by analogy from other areas of the tax law that commodities are includable in inventory only if purchased for a "legitimate business purpose" and "in the ordinary course of business."

Prior to trial, the defendants moved to dismiss the indictment on the ground that the tax law permitted the inclusion of the Rionda purchases in SuCrest's inventory; alternatively, they argued that the tax law was so unclear and undeveloped that they could not, consistently with the Due Process Clause, be convicted of having violated "a *known* legal duty." *United States* v. *Pomponio*, 429 U.S. 10, 12 (1976) (emphasis added). *See also United States* v. *Bishop*, 412 U.S. 346, 360 (1973). Since these decisions hold that "the word 'willfully' in these [tax] statutes generally connotes a voluntary, intentional violation of a *known* legal duty," it followed that the defendants could not have "known" that the Rionda transactions could not be included in inventory if the tax law on this point was undeveloped or unclear. The trial court denied these motions without written opinion.

During the trial itself, the defense focused almost exclusively on the issue of willfulness. The defendants did not contest the

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9 This rule applies even where the goods are held subject to a contemporaneous re-purchase agreement, as was the case here. Rev. Rul. 71-451, 1971-2 C.B. 217.

principal objective facts alleged by the Government; instead, they attempted to demonstrate that the Rionda transactions were not undertaken with an intent to violate a "known legal duty" under the federal tax laws but rather were effected in the good faith belief in their propriety. During the Government's case, for example, a Government witness testified that even after SuCrest's auditors discovered the oral agreement to resell the sugar to Rionda, "Mr. Rapaport continued to believe that that situation was an appropriate one despite the acknowledgement of the oral agreement." (Tr. 327-28; *see also* Tr. 429-30).

The trial court made two decisions at trial that effectively precluded the defense from developing or arguing their defense of lack of willfulness. First, he refused to charge the jury that it could even consider the language and relative clarity of the applicable tax regulations and rulings in assessing willfulness. Second, and equally damaging, he refused to allow the defense to introduce competent proof of the lack of clarity of the governing tax laws at the time of the Rionda transactions.

1. *The Refusal to Instruct the Jurors.* At the close of the Government's case, the defense asked that the jurors be instructed on the actual language of the governing tax law at the time of the Rionda transactions, and be told that they could consider the relative clarity of the tax law in determining willfulness. In the colloquy on this motion, the trial court admitted that the tax law was, in fact, unclear in 1975 and 1976, and indeed that the tax law might have actually permitted the inclusion of the Rionda transactions in inventory. *See, e.g.*, Tr. 1815 (". . . you might be entirely correct about that if this were a civil proceeding, but it is not . . . in the civil area you might be correct"). The trial judge nonetheless reasoned that in a criminal case the Government could prevail by demonstrating evil motive, even if the tax law was unclear or if the transactions were entirely legal: "The issue in this case, it seems to me, is what was in the parties' minds in regard to this transaction. I can't get over that. I don't care whether you are

talking about whether they can include it in inventory or not." (Tr. 1813; *see also* Tr. 1970-71). Relying on this faulty reasoning, the trial judge rejected repeated requests that the jurors be instructed that they could consider the ambiguity of the governing tax regulations as bearing on willfulness. (Tr. 1970-71, 1980).[10]

2. *The Refusal to Admit Evidence.* The defense offered the testimony of two experts in the field of corporate income taxation: Richard B. Stone, Professor of Law at Columbia University Law School and formerly the attorney in the office of the Solicitor General of the United States in charge of tax cases, and David P. Taylor, an attorney and CPA who has written and lectured on LIFO accounting. In *voir dire* testimony, out of the presence of the jury, Messrs. Stone and Taylor testified that well-established principles of tax law and LIFO inventory accounting permitted SuCrest to include the Rionda sugar in inventory, even if it entered into a contemporaneous oral resale agreement with Rionda. (Tr. 1874-1900, 1909-22). Professor Stone in particular testified that the Internal Revenue Code and regulations thereunder appeared to permit the inclusion of such sugar in inventory, and certainly did not provide SuCrest with a basis for predicting that the courts would later reach a different conclusion. (Tr. 1916-18). The Government did not cross-examine these witnesses and offered no challenge to their qualifications as experts. Notwithstanding this fact, and the contrary precedent in two other circuits mandating the admissibility of such testimony, the trial court

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10 The trial court compounded the problem, and insured that the jurors would misunderstand this crucial issue, by charging them (over strenuous objection) that "inventories are defined *by the Internal Revenue Code* as raw material required for sale or manufacture *in the ordinary course of business*." (Tr. 2363) (emphasis added). As the Government acknowledged, the phrase "in the ordinary course of business" does not appear in the Internal Revenue Code or, indeed, in any Treasury Department regulation defining inventories. The court thus incorrectly led the jurors to believe that the law was perfectly clear, and to infer that any violation of it was necessarily willful.

refused to admit the testimony of Professor Stone or Mr. Taylor. (Tr. 1873).[11]

D. The Court of Appeals' Opinion.

On appeal, the defendants' principal arguments were that the trial court erred in refusing to allow the jurors to consider the ambiguity of the tax regulations and rulings in assessing the defendants' alleged willfulness, and in refusing to admit the testimony of Messrs. Stone and Taylor to explain the actual state of the tax law. On both issues, Mr. Rapaport relied on the *en banc* decision in *United States* v. *Garber*, 607 F.2d 92 (5th Cir. 1979).

In *Garber*, the Court of Appeals for the Fifth Circuit reversed a tax conviction because the trial judge refused to instruct the jurors that "a reasonable misconception of the tax law on [the defendant's] part would negate the necessary intent . . . . By withholding this theory, the [trial] court left the jury with the impression that a tax was clearly due and that [the defendant] simply refused to pay it." 607 F.2d at 99-100. The Fifth Circuit also reversed the trial court's exclusion of expert testimony on the ambiguity of the governing tax law, ruling that "the unresolved nature of the law is relevant to show that defendant may not have been aware of a tax liability or may have simply made an error in judgment," *id.* at 98, and that the expert offered competent proof on this issue. Furthermore, relying on the decision of this Court in *James* v. *United States*, 366 U.S. 213 (1961), and decisions in other circuits, the Fifth Circuit concluded that its rulings did not "depend on whether the defendant actually knew of the conflict." 607 F.2d at 98.

Garber was specifically followed by a unanimous panel of the Ninth Circuit in *United States* v. *Clardy*, 612 F.2d 1139 (9th

11 The trial judge did allow the defense to call William Baedeker, an accountant. (Tr. 2027-58). Mr. Baedeker was barred from testifying on the propriety of the Rionda transactions under the governing tax law and was limited to describing the accounting treatment given to them, and thus provided no evidence relevant to the determination of willfulness.

Cir. 1980). In *Clardy*, a federal tax conviction was affirmed after a trial in which the Government was allowed to introduce expert testimony on the state of the tax laws at the time of the criminal acts. The Court approved the use of this expert testimony on the ground that it was "relevant to the issue of willfulness where the theory of the defense is that there is a good faith dispute as to the interpretation of the tax laws. *See United States* v. *Garber*, 607 F.2d 92, 95-99 (5th Cir. 1979) (*en banc*)." 612 F.2d at 1153.[12]

The panel in this case rejected the teaching of both *Garber* and *Clardy* on the grounds that it agreed "with the *Garber* dissent, 607 F.2d at 105, that it would be very confusing to a jury to have opposing opinions of law admitted into evidence as involving a factual question for them to decide." A-19–A-20. Citing two prior non-tax decisions in the Second Circuit that expert opinion on legal issues is inadmissible, the Court concluded that "to the extent that *Garber* is inconsistent with our *Bronston* and *Marx* cases, we decline to follow it." A-20.

REASONS FOR GRANTING THE WRIT

A. The Issue Whether the Ambiguity of the Substantive Tax Law Bears on the Jury's Determination of Willfulness in a Tax Prosecution is a Fundamental One, Upon Which the Circuits are Divided.

As summarized at pp. 7-8, *supra*, prior to this case there has never been a criminal or a civil determination of the propriety of including in LIFO inventory a commodity purchased subject to a resale understanding. The defense contended that the "hedge" transactions involved in this case fell within the language of the governing regulation, and in any event were

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12 Similarly, although it cited neither *Garber* nor *Clardy*, the court in *United States* v. *Baskes*, 687 F.2d 165 (7th Cir. 1981), acknowledged the testimony of a tax attorney who testified as an expert witness for the defendant on the appropriateness of the challenged transactions under the federal tax laws. *Id.* at 168-69.

closely analogous to commodity transactions that for years were effected with the sole purpose of postponing tax recognition from one year to another. *See* pp. 6-7, *supra*. The Government argued that implicit (although concededly not explicit) in the law of inventories was the requirement that inventory purchases be "in the ordinary course of business." See p. 8, *supra*. In short, the tax law was at best unclear, both parties argued only from analogies, and the defendants made a strong argument that the Rionda transactions were in fact permissible under the Internal Revenue Code.

Mr. Rapaport's showing of the ambiguity of the governing tax regulations and rulings was overwhelming and was not contradicted by the Government. This demonstration included:

—The testimony (out of the presence of the jury) of two acknowledged tax experts who concluded that the Rionda transactions were permissible under the Code, and in any event that no one in 1975 or 1976 could have anticipated the contrary position ultimately adopted by the Court of Appeals in this case. *See* pp. 10-11, *supra*.

—The conclusion of Milbank, Tweed, Hadley & McCloy in its 1977 report that the legality of the Rionda transactions was "not free from dispute, and reasonable persons expert in the fields of tax law and accountancy may differ in their interpretation and conclusions." *See* p. 5, *supra*.

—The statement of Milton Scofield, a member of Stroock & Stroock & Lavan (SuCrest's counsel) that an oral resale agreement would not affect the Rionda inventory because the oral agreement would be legally unenforceable (Tr. 1585-86, 1631).

—The acknowledgment of the trial judge, responding to the defendants' argument that the Rionda transactions were permissible, that "you might be entirely correct about that if this were a civil proceeding, but it is not. . . . In the civil area you might be correct." *See* p. 9, *supra*.

Notwithstanding this showing—and indeed, notwithstanding his own acknowledgement of the confused state of the substantive tax law—the trial court refused to instruct the jurors that they could consider the demonstrated uncertain status of the tax law as bearing on the factual determination of whether defendants intentionally violated a "known legal duty." (Tr. 1970-71; 1980). This ruling, and its affirmance by the Second Circuit, is logically wrong and is diametrically inconsistent with the *en banc* decision of the Fifth Circuit in *United States* v. *Garber*, 607 F.2d 92.

In *Garber*, as here, a criminal tax defendant made a showing, by expert testimony and otherwise, that the substantive tax law was at best confused. The ruling of the trial court, identical with the trial court's decision here, was to keep this issue from the jury and to decline any charge to the jury on the ambiguity of the governing tax law or its bearing on willfulness. The Fifth Circuit reversed, reasoning as follows:

> "The parties in this case presented divergent opinions as to the ultimate taxability by analogy to two legitimate theories in tax law. The trial court should not have withheld this fact, and its powerful impact on the issue of Garber's willfulness, from the jury. . . . [T]he court's instructions to the jury . . . took from them the question of the validity of the tax. In effect, the court adopted the government's position that a tax was owing as a matter of law. The court erred by refusing to instruct the jury that a reasonable misconception of the tax law on her part would negate the necessary intent. . . . By withholding this theory the [trial] court left the jury with the impression that a tax was clearly due and that [the defendant] simply refused to pay it."

607 F.2d at 99. This holding is inconsistent with the subsequent holding of the Second Circuit in this case, and was specifically rejected by the Second Circuit panel, which "declined to follow" it. This Court should review the conflict.

Moreover, the panel's decision in this case undermines the validity of this Court's decisions in *United States* v. *Pompo-*

nio, *supra*, 429 U.S. at 12 and *United States* v. *Bishop*, *supra*, 412 U.S. at 360, that a jury must find an "intentional violation of a known legal duty." The "known legal duty" standard surely makes relevant to the jury the factual question how clearly the "legal duty" could be known. This logical connection—which is clearly required by *Pomponio* and which is the basis of the *Garber* decision—was ignored or rejected by the Second Circuit.

B. The Admissibility of Expert Evidence on the Uncertainty of the Substantive Tax Law is Also a Fundamental Issue, Upon Which The Circuits Are Divided.

The defense offered the testimony of two acknowledged experts in the field of LIFO accounting and tax law, each of whom would testify that in 1975 and 1976 no one could predict the court's ultimate determination that the Rionda transactions were not includible in SuCrest's inventory. *See* pp. 10-11, *supra*. In essence, these experts confirmed the previous conclusion of the Milbank firm that the tax issue was "not free from dispute," and that reasonable persons "may differ in their interpretations and conclusions." *See* p. 5, *supra*.

Even though the Government acknowledged those witnesses' credentials and did not cross-examine them, the trial court excluded their testimony on the ground that the evidence related to questions of law, which were "my prerogative." (Tr. 1873). On appeal, this exclusion was affirmed, on the ground that "it would be very confusing to a jury to have opposing opinions of law . . . ." (A-19).

This conclusion, too, is entirely inconsistent with the prior decision in *Garber* and, indeed, with the Ninth Circuit's decision in *Clardy*. In *Garber*, as here, the trial court excluded expert testimony on the ground that it would "confuse the jurors" and because the expert "had never discussed his opinion of the law with the defendant [and thus] it had no relevancy to the fact issue of *Garber's* intent." 607 F.2d at 96. The *en banc* court rejected these and other arguments against such expert testimony, and reversed for a new trial at which the

expert would be allowed to testify. This holding was followed in *United States* v. *Clardy*, 612 F.2d 1139, in which the Government's use of expert testimony to prove the clarity of the governing tax regulations was held "relevant to the issue of willfulness where the theory of the defense is that there is a good faith dispute as to the interpretation of the tax laws." *Id.* at 1153.

In short, two other circuits have unequivocally mandated the admissibility of competent expert evidence on the clarity or ambiguity of the tax law as relevant to a defense based on lack of willfulness. The contrary decision of the panel in this case should be reviewed.

C. There is an Acknowledged and Complete Conflict of Authority On These Issues.

The panel acknowledged that it "agree[d] with the *Garber* dissent" and that it "decline[d] to follow" the Fifth Circuit. It nonetheless made two observations that may be interpreted as diminishing or reconciling the conflict among the circuits.[13] Neither observation carries weight.

1. The Defendant's Subjective Intent.

The panel in this case stated that in *Garber* the defendant "subjectively thought" that the alleged income was "not taxable" and that, in contrast, "there was no evidence" that Rapaport or SuCrest subjectively believed in the propriety of

13 Significantly, the panel did *not* attempt to distinguish *Garber* by claiming that the tax laws involved in this case were clear or unambiguous, and indeed the panel never disputed the trial court's acknowledgment that the law was confused. In its discussion of the defendants' Due Process argument, the Court relied on a subjective test, noting only that "here surely the defendants knew they were committing a wrongful act." A-18. In short, the panel repeated the trial court's faulty assumption that a defendant need not be shown to have violated an actual "known legal duty" if he subjectively *thought* he was committing such a violation. Needless to say, there is absolutely no precedent for this twisted logic; as demonstrated in the text, this reasoning was considered and rejected by the Fifth Circuit.

the Rionda transactions. The court concluded "on the contrary their conduct indicated a subjective belief in the *un*lawfulness of the conduct." (A-19; emphasis in original). This suggestion of a ground for distinguishing *Garber* is invalid, for several separate reasons.

First, as demonstrated at page 9 above, there *was* concrete evidence that Rapaport in good faith believed in the legality of the Rionda transactions; indeed, the argument of lack of willfulness was the keystone of the entire defense.[14]

Second, a requirement that a defendant establish that he subjectively relied on the uncertainty of the tax law before he is allowed to show that the law in fact was uncertain is clearly wrong. It is fundamental that a defendant enjoys a presumption of innocence until proven guilty, that he need not testify, and that the Government bears the burden of proving all elements of a crime—including, in tax cases, the element of willfulness—beyond a reasonable doubt. Particularly given the very specific definition of "willfulness" in tax cases, an ambiguity in the governing tax regulations and laws unquestionably

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14 The panel was apparently impressed by evidence in the record suggesting that the defendants engaged in allegedly dishonest conduct, such as destroying the letter to Rionda assuring it of the resale, making efforts to keep the entire transaction secret, and misrepresenting the facts during the Milbank firm's investigation. A-18. While these facts arguably allow an inference of willfulness, they do not compel one: there was no evidence linking Rapaport to the Rionda letter episode at all; the Government's witnesses acknowledged that secrecy in sugar transactions was industry practice to avoid loss of price advantage (Tr. 359, 848, 981); and the record demonstrated that Rapaport invited a SuCrest employee to attend a meeting with investigators knowing that the employee would reveal the details of the Rionda purchases (Tr. 216, 329).

The point, however, is not that this evidence was disputed, but that it is irrelevant to the legal issues presented here and in the Court of Appeals. The defendants have not raised and do not raise any issue of sufficiency of the evidence; they do claim that they were denied a fair trial because they were not allowed to introduce competent proof to rebut the very evidence upon which the Government (and the panel) relied.

undercuts the Government's assertion of willfulness, and thus should be relevant and admissible even if (as here) the defendant elects not to testify himself. Indeed, serious Fifth Amendment problems would be raised by conditioning the admissibility of this defense upon a showing by the defendant of his subjective intent.

Third, the *en banc Garber* court explored the question of subjective intent at considerable length, 607 F.2d at 98-99, and concluded that subjective belief in the legality of a defendant's conduct is irrelevant to a defense of lack of willfulness if the law in fact is ambiguous:

> "When the taxability of unreported income is problematical as a matter of law, the unresolved nature of the law is relevant to show that defendant may not have been aware of a tax liability or may have simply made an error in judgment. . . . Furthermore, the relevance of a dispute in the law does not depend on whether the defendant actually knew of the conflict."

607 F.2d at 98 (citations omitted). After reviewing precedent in many other courts, including the decision of this Court in *James* v. *United States*, 366 U.S. 213 (1961), the court determined that actual subjective reliance is unnecessary.

> "To hold otherwise would advocate convicting an unsophisticated taxpayer who failed to seek expert advice as to whether certain income was taxable while setting free a wise taxpayer who could find advice that taxes were not due on the identical type of debatably taxable income."

Id. See also United States v. *Critzer*, 498 F.2d 1160, 1163 (4th Cir. 1974) ("the uncertainty created by *Wilcox* [a precedent on the tax issue] as a matter of law precluded a demonstration of 'willfulness,' without regard to the defendant's actual state of mind with respect to his knowledge or reliance on *Wilcox*").

In *United States* v. *Clardy*, where expert evidence on the law's ambiguity was held admissible, it does not appear from the court's opinion that the defendant introduced any evidence

at all on his subjective belief, and the panel based its approval of *Garber* on the ground that expert testimony is "relevant to the issue of willfulness where the *theory* of the defense is that there is a good faith dispute as to the interpretation of the tax laws." 612 F.2d at 1153 (emphasis added).

In short, even if the Second Circuit's requirement of subjective reliance were logical and factually apposite (which it is not), both the Fifth and Ninth Circuits have rejected the requirement.

2. The *Herzog* Decision.

The panel concluded its discussion of *Garber* by noting that "the Fifth Circuit has itself limited *Garber* in *United States* v. *Herzog*, 632 F.2d 469, 473 (5th Cir. 1980)." A-20. Leaving aside the question whether a panel decision may "limit" a previous *en banc* ruling, the decision in *Herzog* (by a divided panel) does not provide any basis for diminishing the significance of the panel's decision in this case or of its irreconcilable conflict with *Garber* and *Clardy*.

In *Herzog*, the defendant was convicted of filing false tax withholding exemption statements. The defendant offered no proof or argument that the statements were in fact true or that the law prohibiting fraudulent statements was ambiguous or unclear. Rather, the defendant offered the testimony of a purported expert "that the tax laws are complex and that even law students, law professors, and attorneys find the subject very difficult." *Id.* at 473. In short, the defendant claimed that since the tax laws *in general* are complex, filing a fraudulent statement might have been an honest mistake.

A divided panel of the Fifth Circuit affirmed the exclusion of this proof, reasoning that the willfulness of filing a false form is not explained or diminished by testimony concerning the general complexity of the tax laws:

> "[H]e is charged with filing false exemption forms, and no amount of expert testimony could help him in this regard."

Id. The majority nonetheless reaffirmed the "rationale of *Garber*" that expert testimony is admissible "to demonstrate the vagueness of the law, which would preclude a willful intent to violate it." *Id.* The dissenting judge (who had previously dissented from the *en banc* decision in *Garber*) believed that the expert testimony was relevant to support the reasonableness of the defendant's claim that he was exempt from tax in the first place, and would have reversed the conviction. *Id.* at 475.

Herzog did not overrule or even limit *Garber*, but simply declined to extend it to a new area where the rationale of *Garber* has no application. The opinion of the dissenting judge—himself a dissenter in *Garber*—to extend *Garber* to the *Herzog* facts effectively rebuts any notion that the Fifth Circuit wishes to withdraw from *Garber*. If anything, the *Herzog* decision shows that *Garber* announced a reasonable and practical rule that will not be mechanically applied in every tax case and that will not unduly create confusion in the administration of the tax laws.

CONCLUSION

The Fifth Circuit has noted that the Government frequently uses a "criminal proceeding pursuant to section 7201 [as a] vehicle for pioneering interpretations of tax law." *United States* v. *Garber, supra,* 607 F.2d at 100. The circuits are irreconcilably split, however, on the rights of defendants charged in such prosecutions. The Fifth Circuit (*en banc*) and the Ninth Circuit have held that the relative clarity or ambiguity of the governing tax rules and regulations is relevant to the factual determination of willfulness, and that competent expert proof on the clarity of the tax law is thus admissible. The Second Circuit panel in this case rejected these principles, expressly "declined to follow" the Fifth and Ninth Circuits, and held that the uncertain state of the applicable tax rules is irrelevant and proof of it inadmissible.

The issues presented in this petition are fundamental and will frequently arise in federal tax prosecutions.[15] This Court has ruled that tax prosecutions are based on a very specific definition of "willfulness" as an "intentional violation of a known legal duty." The Second Circuit's reasoning—that jurors should not be allowed to learn that the "legal duty" the defendant was charged with having "known" was in fact unclear—is suspect, and prevents defendants from raising a defense expressly made available in other jurisdictions. The Court should resolve the conflict among the circuits.

Respectfully submitted,

FREDERICK T. DAVIS

Attorney for Robert M. Rapaport
30 Rockefeller Plaza
New York, New York 10112
(212) 541-4000

Of Counsel:

Leslie C. Levin

Patterson, Belknap, Webb & Tyler
30 Rockefeller Plaza
New York, New York 10112
(212) 541-4000

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15 The *Garber* decision has aroused a lively controversy among commentators. The panel relied in part upon a student Note, *Criminal Liability for Willful Evasion of an Uncertain Tax*, 81 Colum. L. Rev. 1348 (1981), which is critical of *Garber*. *Garber's* reasoning has been approved in Fink, *Tax Fraud—Audits, Investigations, Prosecutions* § 18.04[5] (1981).

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 124, 144—August Term, 1982

(Argued October 20, 1982 Decided January 5, 1983)

Docket Nos. 82-1128, 82-1144

UNITED STATES OF AMERICA,

Appellee,

—v.—

INGREDIENT TECHNOLOGY CORPORATION, formerly known as SUCREST CORPORATION, and ROBERT M. RAPAPORT,

Appellants.

Before:

OAKES and WINTER, *Circuit Judges,*
and METZNER, *District Judge.**

Appeal by corporation and its former president for tax fraud conviction after jury trial in the United States

* Of the Southern District of New York, sitting by designation.

District Court for the Southern District of New York, Robert L. Carter, Judge, finding that defendants willfully engaged in scheme to overstate "LIFO" inventory through pretended purchase of raw sugar in 1975 and conspired to do so in 1976.

Affirmed.

JULES RITHOLZ, Kostelanetz & Ritholz, New York, N.Y. (Eliot Silverman, David Axelrod, Kostelanetz & Ritholz, New York, N.Y., of counsel), *for Appellant Ingredient Technology Corp.*

FREDERICK T. DAVIS, Patterson, Belknap, Webb & Tyler, New York, N.Y. (Leslie C. Levin, Patterson, Belknap, Webb & Tyler, New York, N.Y., of counsel), *for Appellant Rapaport.*

MINNA SCHRAG, Assistant United States Attorney for the Southern District of New York, (John S. Martin, Jr., United States Attorney for the Southern District of New York, Charles M. Carberry, Warren Neil Eggleston, Walter P. Loughlin, Assistant United States Attorneys for the Southern District of New York, of counsel), *for Appellee.*

OAKES, *Circuit Judge*:

This appeal is by a corporation and its former president from judgments of conviction for tax fraud by means of year-end LIFO ("last-in-first-out") inventory overstatement. The principal arguments of both defendants before the jury in a trial in the United States District Court for the Southern District of New York, Robert L. Carter, Judge, were that the inventory was not overstated because the corporation in fact had legal title on the year-end date to the property in question—raw sugar—even though it had previously agreed to resell it to its seller, and that in any event the element of willfulness was negated because the tax laws were too unclear for the defendants to have known that they had committed a crime. Other arguments based on evidentiary rulings, the court's charge, the statute of limitations, the proof, and a claim that a corporation as a matter of law cannot be convicted of perjury under 26 U.S.C. § 7206(1) are made on appeal. We affirm the convictions.

FACTS

The appellants include Ingredient Technology Corp., which used to be known as SuCrest Corp., and its former president, Robert M. Rapaport. These two were charged in a five-count indictment along with SuCrest's treasurer, Allerton D. Marshall, who was acquitted on all charges. SuCrest and Rapaport were convicted on Count One for conspiracy to evade SuCrest's corporate income tax for fiscal 1975 (18 U.S.C. § 371). Count Two, on which the jury was unable to agree, is irrelevant here. SuCrest and Rapaport were convicted on Count Three for conspiracy to defraud the United States by impeding the Department

of the Treasury in the collection of revenue in connection with SuCrest's federal income tax for fiscal 1976 (18 U.S.C. § 371). SuCrest was convicted on Count Four for its subscribing to a false federal income tax return in fiscal 1975 (26 U.S.C. § 7206(1)); this is the count for which SuCrest claims it cannot be liable as a matter of law. Rapaport was convicted on Count Five for assisting SuCrest in the presentation of a false corporate federal income tax return for fiscal 1975 (26 U.S.C. § 7206(2)).

During 1974 through 1976 SuCrest, a publicly traded company with annual sales in the hundreds of millions of dollars, was principally in the sugar refining and sales business, buying raw sugar for refining from brokers (operators) who either imported raw sugar or bought it from domestic producers. SuCrest had never been in the business of selling raw sugar or buying raw sugar for resale. Rapaport, who was president and chief executive officer of SuCrest, actively participated in the operation of the Sweetener Division which refined and resold refined sugar, and in the tax years in question his approval was required for every purchase of raw sugar. These purchases at any one time involved ten to twenty tons.

In 1974 the price of raw sugar began to fluctuate widely and although SuCrest was making large gross profits as a result of price fluctuations upward, taxes on those profits and the escalating cost of raw sugar depleted its income. Like many other United States sugar refiners, SuCrest switched in 1974 to the LIFO inventory accounting method for its "raw sugar and raw sugar content in goods in process and in finished goods." Under LIFO, of course, the most recently purchased raw materials represent the cost of inventory attributable to costs of goods sold. In this inflationary period, therefore, LIFO pro-

duced a higher cost of goods sold which in turn resulted in lower taxable income than the FIFO (first-in-first-out) method formerly used. Moreover, LIFO more accurately reflected real costs because profits had to be reinvested in increasingly expensive raw materials. Thus in the fiscal year in which SuCrest adopted the LIFO accounting method—1974—it was able to report and to carry forward a loss of about $14.7 million as opposed to a taxable income of $12.2 million which it otherwise would have had to report. This substantial tax saving occurred as a result of large purchases of raw sugar; SuCrest accumulated an unusually large inventory of about 194 million pounds which thereupon constituted what is called the "LIFO base." In SuCrest's case this was valued at about ten cents per pound and, as the accountants insist to those who adopt the LIFO method, it was important to maintain this LIFO base, because if the amount of sugar fell below its level, then an equivalent amount of sugar valued at only ten cents per pound (as opposed to higher subsequent prices) would have to be attributed to that given year's cost of goods sold, with the result that profits and taxes would be increased.

In 1975 and 1976, with both raw sugar prices and interest rates increasing, SuCrest operated its refineries with as little raw sugar on hand to be processed as possible, slightly less than 100 million pounds or about half of the 1974 year-end inventory or LIFO base. Because this would have caused large 1975 profits and taxes, it was determined to add enough raw sugar to the inventory level so as not, in accounting terms, to "invade" the LIFO base before the end of the fiscal year, in this case May 31, 1975. SuCrest could have done so simply by purchasing raw sugar on the open market, but such a

purchase would involve market risks, capital outlay, possibly high interest expenses, and the like. Management set upon another course, resulting in the instant convictions.

The method adopted had the overall effect of involving no financial risk, with title to sugar being taken before the end of the fiscal year but immediately thereafter resold to the seller, with the sugar never entering any flow of raw materials for the refining process, and the only expense being the payment of a small fee to the cooperating operator. More specifically, what was done was the following.

Arrangements were made with one of SuCrest's operators, Czarnikow-Rionda Co. (Rionda), whereby it would sell to SuCrest the quantity of raw sugar SuCrest needed to protect its LIFO base and SuCrest would then sell the raw sugar back to Rionda so that SuCrest would be able to claim formal title without having to take physical delivery and with neither side making a profit on the transaction. In addition, SuCrest and Rionda engaged in an elaborate pricing formula hinged to the market value of raw sugar on the futures exchange because the volatile price fluctuations in the sugar market could result in a resale at a price different from the original purchase price so that either SuCrest or Rionda would stand to lose on what was intended to be simply a bookkeeping transaction. It was agreed that Rionda would sell sugar to SuCrest at 1.075 cents per pound above the July 1975 futures price on the New York Coffee and Sugar Exchange on the day of the sale and buy the sugar back at 1.0 cent above that same futures price on the day of the resale, with the difference of .075 cent going to Rionda as the only SuCrest expense in the transaction. Then SuCrest and Rionda each agreed to take opposite and identical futures positions on the Exchange, which in turn assured

no gain or loss for either party since any gain from the resale of the physical sugar as the result of an increase in sugar price would be matched and offset by an equivalent loss on the futures contracts or vice versa.

SuCrest's contract to purchase 50,000 long tons of raw sugar from Rionda, executed on April 18, 1975, the day SuCrest and Rionda opened their futures positions, was in writing. Rionda's agreement to repurchase was not. Supposedly because of "gossip among sugar buyers," SuCrest brief at 12, Rapaport cautioned one of his juniors not to discuss the details of the Rionda transaction "on the street."

Prior to the close of the SuCrest fiscal year, Rionda in accordance with the purchase contract "declared" to SuCrest title to the cargoes of the two ships Ally and St. Etienne involving 41,755 long tons of raw sugar. It turned out that the remaining 8,245 long tons due under the contract were not required by SuCrest to maintain its LIFO base and they were declared after the end of SuCrest's fiscal year in June 1975. Almost immediately thereafter and while the vessels were still at sea, the same sugar was resold to Rionda. Checks were exchanged for the purchase and resale and for the net changes in the futures positions. SuCrest never actually drew on its funds to pay the nearly $29 million due for the sugar. Rionda made its "commission" of $84,000. Except for satisfying the accountants and the lawyers and ultimately the Government, the transaction was at an end.

Significantly, two facts were not disclosed until a later time. One was that Rionda's vice president, who had entered into the understanding with SuCrest as to the overall transaction, had about a week after April 18 asked for a letter that would set out the terms of the resale, a letter which a SuCrest executive and the Rionda vice

president sealed with wax and placed in the latter's safe. After the transaction was completed, the two men met and destroyed the letter. Significantly also, after Rionda had declared title to the sugar to SuCrest but before the resale, Rionda declared title to the sugar on board the St. Etienne to another customer pursuant to a contract that had been made several weeks earlier. In other words, the transaction was, so far as Rionda was concerned, a total sham. The principal question before the jury was whether, so far as SuCrest and Rapaport were concerned, the transaction was the same.

The company's auditors questioned the subsequent resale despite the fact that there were separate documents for all of the transactions other than the agreement to resell or, on the part of Rionda, repurchase. The auditors in fact obtained an opinion letter from the company's attorneys which stated that, based upon representations received from SuCrest employees that as of the end of the fiscal year SuCrest had no commitment to resell and Rionda no commitment to repurchase the sugar, SuCrest did own the sugar at the end of the fiscal year. The auditors, who were told by Rapaport and Marshall that all data concerning commitments had been made available, that the scope of the auditors' examination had not been restricted, and that "goods for which the company was accountable to others . . . had been excluded from inventories," were left in the dark as to the prearranged agreement of resale. SuCrest accordingly reported cost of goods sold on the basis of the year-end purchase of inventory, thereby understating the SuCrest 1975 operating profit by about $13.7 million.

SuCrest's fiscal year 1976 was also involved. The price of sugar declined after April, 1975, and another similar sale with Rionda was arranged, this time for 60,000 long

tons of raw sugar. The only variations from the preceding year's elaborate arrangements were that SuCrest obligated itself to pay Rionda's commissions for the future trades, covered its own and Rionda's margin requirements, and instead of having a slight variation in the pricing formula was to give Rionda simply a straight $25,000 fee. The fixed differential in the pricing formula, that is to say the figure that was to be added to the price at which July, 1976, futures were trading on the day the raw sugar was purchased and on the day when it was eventually resold, was set at 3.25 cents per pound. The written contract of purchase by SuCrest was dated August 5, 1975, with title not to be declared until May, 1976, and delivery in June or July of 1976. Opposite and identical 1,200-lot futures positions were opened, although they were not shown on reports of open futures positions. In late May, 1976, Rionda declared title to SuCrest to the sugar in three vessels at sea in satisfaction of the August 5, 1975, contract, and during June, 1976, while the vessels were still at sea SuCrest resold the same sugar back to Rionda with the resale prices set according to the formula previously used containing a 3.25-cent fixed differential. The futures positions were mutually reversed, and again each party ended up in exactly the same position as it had been before except for Rionda's obtaining a $25,000 fee and about $74,000 in commissions. The 60,000 long tons of raw sugar were entered on the books and presented to the auditors as such. Meanwhile, however, the raw sugar buyer of SuCrest in the Sweetener Division had told one of the members of the auditing team "off the record" about the resale aspect of the 1976 transaction. False explanations for the resale were given to the auditors in Rapaport's presence by some of his managers, and questioning of a Rionda vice presi-

dent elicited a response that the resale was unrelated to the original purchase by SuCrest. Again, the SuCrest auditors asked counsel for an opinion. Eventually the board of directors was advised by the company vice president who was president of the Sweetener Division that the resale had been prearranged. Audit procedures were expanded. Outside counsel was hired to ascertain the facts and concluded that the Rionda transactions had no substance and that the Rionda sugar purchase should not be included in the 1975 and 1976 computations of costs of goods sold. SuCrest filed its 1976 tax return based upon outside counsel's report and gave no recognition to the Rionda transactions.[1]

DISCUSSION

The primary argument made by both SuCrest and Rapaport is that as a matter of law the Rionda sugar was properly includable in SuCrest's LIFO inventory because SuCrest both had title and bore the risk of loss, satisfying the requirements for inclusion in inventory under the Internal Revenue Code Section 471[2] and Treasury Regulation Section 1.471-1.[3] SuCrest points to the portion of

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1 The SEC filed a complaint against the appellants here, Rionda and two other SuCrest executives, each of whom agreed to consent judgments. Rionda also pleaded guilty to two counts of assisting SuCrest in the presentation of false tax return information (26 U.S.C. § 7206(2)).

2 26 U.S.C. § 471 provides:

> Whenever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

3 Treas. Reg. § 1.471-1 provided:

> *Need for Inventories.* In order to reflect taxable income correctly, inventories at the beginning and end of each taxable year are

Regulation Section 1.471-1 which requires that "[m]erchandise should be included in the inventory only if title thereto is vested in the taxpayer . . . . although such merchandise is in transit" but should "exclude from inventory goods sold . . . title to which has passed to the purchaser," an event which had not taken place here. *See also* Rev. Rul. 71-451, 1971-2 C.B. 217,[4] Rev. Rul. 81-272, 1981-2 C.B. 116. SuCrest argues that the Treasury Regulation makes "goods under a contract of sale" includable in inventory so long as SuCrest retains title; that SuCrest acquired the sugar "for sale" and not for use in SuCrest's business; and that title to the goods passed

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necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. The inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale, in which class fall containers, such as kegs, bottles, and cases, whether returnable or not, if title thereto will pass to the purchaser of the product to be sold therein. Merchandise should be included in the inventory only if title thereto is vested in the taxpayer. Accordingly, the seller should include in his inventory goods under contract for sale but not yet segregated and applied to the contract and goods out upon consignment, but should exclude from inventory goods sold (including containers), title to which has passed to the purchaser. A purchaser should include in inventory merchandise purchased (including containers), title to which has passed to him, although such merchandise is in transit or for other reasons has not been reduced to physical possession, but should not include goods ordered for future delivery, transfer of title to which has not yet been effected. (But see § 1.472-1.)

4 Rev. Rul. 71-451 involved a contract of sale or return used by a garden seed producer, which did not treat seeds delivered to dealers under such a contract as sales. Following *J.J. Little and Avis Co. v. Commissioner*, T.C. Memo 1966-68, the Service ruled that income accrued to the producer when title passed, i.e., on delivery to a common carrier, and that seeds so delivered could not be included in inventory. In that situation neither party knew what portion, if any, of the seeds would be returned, whereas here both parties knew that all the raw sugar would be returned. There the business purpose of the contract of sale or return was to give the dealers an inventory for resale to customers. Here there was no way in which SuCrest was to use the Rionda sugar.

under New York Uniform Commercial Code Sections 2-401, 2-501, which in turn is said to have passed the risk of loss to SuCrest. *Id.* § 2-509. Thus, even if the oral understanding between SuCrest and Rionda amounted to a contract of resale, the argument runs, SuCrest could still include the sugar in its inventory. Moreover, it is said, the oral resale agreement involved the sale of goods in excess of $500 which was not an enforceable contract because it was not in writing as it must be under the New York Statute of Frauds. *Id.* § 2-201(1). It is also contended that the unsigned letter in the Rionda safe was not enforceable by SuCrest or Rionda because the executive who signed the letter on behalf of SuCrest never was authorized to do so. Support for this last point is said to lie in Rev. Rul. 71-451, 1971-2 C.B. 217, *see supra* note 4, and cases to the effect that it is immaterial that SuCrest may have intended to resell the sugar before it actually did sell. The hedging transaction was said to be a normal hedge which does not make for inventory ineligibility. *Monfort of Colorado, Inc. v. United States*, 561 F.2d 190 (10th Cir. 1977); Rev. Rul. 74-226, 1974-1 C.B. 119;[5] Rev. Rul. 74-223, 1974-1 C.B. 23.[6] SuCrest made an elaborate argument to the jury and argues to us that because the futures prices involved cover only the cost of the raw sugar and not the cost of insurance and freight, that is to

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5 Rev. Rul. 74-226 dealt with commodities dealers on organized exchanges who are required to maintain inventories, and ruled that they are entitled to value goods on hand at market value when engaged in "carrying operations" or "straddles." There the purchase or sale of commodities was an income-producing factor.

6 Rev. Rul. 74-223 also dealt with commodities dealers and ruled that they may take into account gains or losses based upon the market value of such open futures contracts to which they are parties as are hedges against actual spot or cash transactions or against "forward" sales or purchases, but not of purely speculative transactions not offset by such transactions or such sales and purchases.

say, are on an FOB basis, whereas the price for a purchase of actual sugar is CIF, i.e., includes the cost of insurance and freight, the difference, that cost, amounts to the "CIF differential" which, of course, is also subject to a certain amount of market fluctuation. The theory presented is that the elaborate purchase of opposite and identical futures was so as to hedge the CIF differential which was not hedgable merely by going short on the futures contract.

Having satisfied the formal requirements of what it sees as the applicable rules, SuCrest urges us to understand its elaborate machinations as a legitimate ploy to hold down taxes and directs us to the maxim that a person is entitled to arrange his taxes so as to pay only that which is due. But, of course, the taxpayer is not permitted to avoid taxes which *are* due and the invocation of the phrase tells us nothing about what must ultimately be rendered unto the I.R.S. any more than Socrates solved the thorny problems of justice by defining it to require that we give every person his due. *See* P. Westen, "The Empty Idea of Equality," 95 Harv. L. Rev. 537, 556-58 (1982). At best such maxims, which Roscoe Pound labeled "minims" because they revealed so little, *Sheppard v. United States*, 361 F.2d 972, 977 n.9 (6th Cir. 1966), are "singularly unhelpful when it comes to deciding cases," *Goldstein v. Commissioner*, 364 F.2d 734, 741 n.7 (2d Cir. 1966). As a starting point, they are at best confusing. *See, e.g., Grove v. Commissioner*, 490 F.2d 241 (2d Cir. 1973). *See generally Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945); *Gregory v. Helvering*, 293 U.S. 465, 470 (1935).

These conclusory maxims are less confusing if we regard them *as* conclusions for substantive analysis and the substance underlying the transaction is taken to be the

start. Two factors guide us here. First, we agree with Judge Learned Hand in dissent in *Gilbert v. Commissioner*, 248 F.2d 399, 412 (2d Cir. 1957), that it is immaterial whether we are talking about "substantial economic reality," "substance over form," "sham" transactions, or the like; rather the question is whether under the statute and regulations here involved the transaction affects a beneficial interest other than the reduction of taxes. And here we note that the very first sentence of Section 1.471-1 makes inventories necessary in the first instance "in every case in which the production, purchase, or sale of merchandise is an *income-producing factor*." (Emphasis added.) Thus, while title may be necessary for inclusion in inventory, it in itself is not alone sufficient, at least where the parties' purpose is solely tax avoidance. *See United States v. Balanovski*, 236 F.2d 298, 306 (2d Cir. 1956), *cert. denied*, 352 U.S. 968 (1957). Here, from the beginning, it was never intended that the sugar which was on board ship would be for SuCrest "an income-producing factor." On the contrary, it was never intended to be refined, and SuCrest was not in the business of selling or brokering raw sugar. SuCrest would have us give meaning to inventory which was never intended to be used or sold in the regular course of business. In fact, the transaction was designed *not* to earn money for SuCrest. Irrespective of legal enforceability of the contract of resale, whether under Restatement Section 90 or otherwise, the fact that Rionda was one of SuCrest's regular operators and was paid in effect a commission indicates that Rionda had a business interest in going through with the 1975 transaction, a business interest which was further demonstrated by its willingness to go through the same charade in 1976. There was absolutely no beneficial interest on the part of SuCrest except to inflate inventory for a few days

solely for tax purposes, and there was no prospect of gain from the transaction; indeed it was sure to lose in terms of brokerage commissions and Rionda's fee for engaging in it, however depicted to SuCrest. The fact that Rionda's obligation to repurchase may have been unenforceable, however it may be examined, does not affect SuCrest's purpose to avoid taxes which would have occurred irrespective of such enforceability; the only thing that lack of enforceability shows, if indeed there were such, is that the scheme might not have succeeded in its true goal of losing money only to the extent of the brokerage commissions and fee to Rionda. This "beneficial interest factor" alone should be sufficient in this case to disqualify SuCrest's purchase from its LIFO base.

Second, as *Corliss v. Bowers*, 281 U.S. 376, 378 (1930), stated broadly, "taxation is not so much concerned with the refinements of title as it is with *actual command* over the property taxed." (Emphasis added.) SuCrest argues that as of the end of the fiscal year it had title to the sugar and therefore enjoyed the right "to take possession of the sugar, to refine it, or to sell it," and suffered the hazard that "if the ships had sunk, or if the sugar had become so damaged as to become unmarketable, SuCrest would have had to bear the risk of economic and physical loss." Brief at 31. This, of course, assumes that Rionda was not in fact in control of the sugar. On this score, Rionda had none of the illusions that SuCrest urges us to abide here: Rionda declared title to the sugar to third parties even before the sugar was sold back by SuCrest. It is only on the issue of actual control of the property that SuCrest's argument that its contract with Rionda was unenforceable has any significance. At the outset, we note that "[t]ax consequences follow what has taken place, not what might have taken place," *Central Tablet Manufacturing*

Co. v. United States, 417 U.S. 673, 690 (1974), and the resale agreement was completely obeyed here. Second, it would be high irony to find that the defendants here are immune to prosecution for their scheme because they never wrote it down. The reason it was never written down, and the reason that the copy sealed in wax was destroyed, is that such a document would prove that they had agreed to resell at the time of sale and would close the case against them in a prosecution like this one. In short, the contract was never written because it was illegal, and we decline the defendants' invitations to apply the Statute of Frauds not as a measure to protect the parties to contracts but as a means to promote frauds on the government.[7]

We conclude that the concept of inventory from an accounting point of view and the term inventory in the applicable Treasury Regulations would be meaningless were there to be included in the term or concept property bought, agreed to be resold, never intended to be utilized in the trade or business of the taxpayer (except for tax purposes), and in fact under the corporate taxpayer's dominion, control, and at itw risk about as long as the pea in the proverbial shell game is under the shell.

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7 We also duly note the nice distinction made in the SuCrest brief at 34 and n.* between unenforceable oral resale agreements such as were disregarded by the Court of Claims in a case involving the issue whether a bank holding municipal bonds as collateral for a bond dealer's loan was subject to the tax exemption for interest on municipal securities, *Citizens National Bank v. United States*, 551 F.2d 832, 841 (Ct. Cl. 1977), and cases involving a similar issue involving written and enforceable resale agreements, e.g., *Union Planters National Bank v. United States*, 426 F.2d 115 (6th Cir. 1970) (burden did not assume risk of fluctuations in market value of bonds). The appellants would like to have us apply a similar distinction here, even though the issue before us relates to the entirely distinguishable category of inventories and not to the deductibility of interest on bonds held as collateral.

The next argument, which is on due process grounds but also goes to the court's exclusion of proffered expert testimony and refusal to instruct the jury, is that the convictions must be reversed because the applicable tax law was at least in such dispute that it was not sufficiently clear at the time of the Rionda transactions to provide a "clear and definite statement of the conduct proscribed" under *United States v. Chiarella*, 588 F.2d 1358, 1377 (2d Cir. 1978) (dissenting opinion), *rev'd*, 445 U.S. 222 (1980), thereby negating the element of willfulness or scienter.[8]

We agree that a criminal statute must meet the requirements of the Due Process Clause and be sufficiently definite as to "give a person of ordinary intelligence fair notice that his contemplated conduct is forbidden." *United States v. Harris*, 347 U.S. 612, 617 (1954). *See also Bouie v. City of Columbia*, 378 U.S. 347, 352 (1964). But as this court has noted,

> All the Due Process clause requires is that the law give sufficient warnings that men may conduct them-

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8 SuCrest and Rapaport concede that in 1979 the Internal Revenue Service issued Rev. Rul. 79-188, 1979-1 C.B. 191, which took the position that property not intended by the taxpayer to be used in business could not be included in inventory to avoid invasion of a LIFO base. But it is argued that the very fact that the Service issued this ruling proves that the question was not settled in 1975. The issuance of the LIFO Revenue Ruling in 1979 on which the appellants rely by no means signifies a lack of clarity in the law at the time the SuCrest-Rionda transaction was entered into in 1975. In the first place, the ruling goes to different facts, since under it the purchase and resale were not prearranged, the prices were not structured to eliminate the possibility of profit or loss on the resale, and there were no indicia of concealment. Moreover, as Revenue Ruling 79-188 itself points out, "the purpose for which raw material is purchased is a major factor whether such material is inventoriable by the taxpayer," and has been since *Latimer-Looney Chevrolet, Inc. v. Commissioner*, 19 T.C. 120 (1952) *acq'd in* 1953-1 C.B. 5, which the Ruling cites for that proposition.

> selves so as to avoid that which is forbidden, and thus not lull the potential defendant into a false sense of security, giving him no reason even to suspect that his conduct might be within its scope.

United States v. Herrara, 584 F.2d 1137, 1149 (2d Cir. 1978). And of course it is immaterial that "there is no litigated fact pattern precisely in point." *United States v. Brown*, 555 F.2d 336, 339-40 (2d Cir. 1977). Here surely the defendants knew they were committing a wrongful act. *United States v. Dixon*, 536 F.2d 1388, 1397 (2d Cir. 1976). The resale component of the agreement was concealed. The auditors were lied to, as were the attorneys. The secret letter sealed with wax was hidden in a safe and then destroyed. *Cf. United States v. Feola*, 420 U.S. 671, 685 (1975) (conviction for assaulting federal officer upheld despite defendant's ignorance of victim's official identity). Willful intent was a question of fact decided by the jury at trial contrary to the defendants. *United States v. Pomponio*, 563 F.2d 659, 662 (4th Cir. 1977), *cert. denied*, 435 U.S. 942 (1978).

The more sophisticated argument is made that the district court's exclusion of the testimony offered by two of defendant's experts, coupled with the decision of the trial court not to instruct the jury in terms of Treasury Regulation § 1.471-1, thwarted the defense that the defendants could not have formed a willful intent. Rapaport argues that the clarity of whatever legal duty was owed has become, in this case, an issue of fact and not of law. The defendants point to *United States v. Garber*, 607 F.2d 92 (5th Cir. 1979) (en banc), a case involving a prosecution for tax evasion for having failed to report income from the sale of the taxpayer's blood containing a rare and valuable antibody, where the Fifth Circuit held

exclusion of the testimony of a tax expert that in his opinion the income was not taxable was erroneous and reversed the conviction. Indeed, it is pointed out, the Fifth Circuit went further to say that the relevance of a dispute in the law "does not depend on whether the defendant actually knew of the conflict." *Id.* at 98, citing *United States v. Critzer*, 498 F.2d 1160 (4th Cir. 1974). *See also United States v. Clardy*, 612 F.2d 1139, 1153 (9th Cir. 1980) (government expert's testimony relative to issue of willfulness admissible where defense theory is that there is good faith dispute as to tax law interpretation). We decline to apply the *Garber* reasoning for two reasons. First, the holding of that case was that in view of the defense that Ms. Garber "subjectively thought that proceeds from the sale of part of her body were not taxable" exclusion of an accountant's expert testimony that money obtained from the sale of blood plasma was not taxable income was reversible error. Here, however, there was no evidence that Rapaport or anyone else at SuCrest genuinely thought that what they were doing was lawful and proper; on the contrary, their conduct indicated a subjective belief in the *un*lawfulness of the conduct. Second, as pointed out in Note, *Criminal Liability for Willful Evasion of an Uncertain Tax*, 81 Colum. L. Rev. 1348, 1360 (1981), the *Garber* majority's approach permits juries to find that uncertainty in the law negates willfulness whether or not the defendants are actually confused about the extent of their tax liability. In contrast, prior cases on willfulness consistently require factual evidence of the defendants' state of mind to negate willfulness under any theory. *See id.* at 1357. We agree with the *Garber* dissent, 607 F.2d at 105, that it would be very confusing to a jury to have opposing opinions of law admitted into evidence as involving a factual question for

them to decide. Indeed, as that dissent points out, the inevitable logic of the majority's decision in *Garber* is that if the tax law is uncertain, the indictment should be dismissed. Questions of law are for the court. *United States v. Bronston*, 658 F.2d 920, 930 (2d Cir. 1981), *cert. denied*, 102 S.Ct. 1769 (1982); *Marx & Co. v. Diners Club, Inc.*, 550 F.2d 505, 509-10 (2d Cir.), *cert. denied*, 434 U.S. 861 (1977). *See also* 7 Wigmore, *Evidence* § 1952 at 81. To the extent that *Garber* is inconsistent with our *Bronston* and *Marx* cases, we decline to follow it. We note that the Fifth Circuit has itself limited *Garber* in *United States v. Herzog*, 632 F.2d 469, 473 (5th Cir. 1980) (expert's view of tax laws irrelevant to willfulness issues since complexity of laws sheds no light on defendant's intent).

The court's instructions were proper concerning willfulness, an issue which is a question of fact to be determined by the jury. *Spies v. United States*, 317 U.S. 492, 500 (1943). The instructions as set forth in the margin[9] gave,

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[9] I instruct you that a transaction without economic substance which is entered into solely for the purpose of tax avoidance can't properly be used to compute taxes. The government contends that an agreement simultaneously to purchase and resell the same amount of raw sugar on terms that guarantee no risk of loss or chance for gain has no economic significance.

A taxpayer may of course try to pay as little tax as possible so long as he uses legal means. Transactions may be arranged in an attempt to minimize taxes if the transactions have economic substance. The defendants contend that the Rionda transaction had economic substance. They claim that SuCrest had title to the sugar purchased from Rionda, had risk of loss with respect to such sugar, had a binding obligation to resell the sugar at a fixed price and had a business purpose in entering into the Rionda transaction.

As a final instruction on this count, I will discuss certain terms you have heard used throughout the trial:

Inventories are defined by the Internal Revenue Code as raw material acquired for sale or manufacture in the ordinary course of business.

in our opinion, all that is necessary: a fair presentation of the defense's contentions. *United States v. Park*, 421 U.S. 658, 674-75 (1975). Instructions given in the precise terms of the Treasury Regulation would invite the jury to interpret the law which is, as we have said, a matter for the judge. *See United States v. Lanni*, 466 F.2d 1102, 1110 (3d Cir. 1972).

The remaining arguments of appellants are no more persuasive. They contend that in connection with the 1976 tax return no conspiracy to defraud was alleged because the transactions were not reflected in SuCrest's 1976 tax return and no such conspiracy was accordingly established. They rely on the decision in *United States v. Tarnopol*, 561 F.2d 466, 474 (3d Cir. 1977), that the mere keeping of false books and records does not amount to a conspiracy to defraud the United States in connection with the collection of revenue under 18 U.S.C. § 371. A specific statute dealing with revenue matters was construed as early as *Haas v. Henkel*, 216 U.S. 462, 479

Inventories, as so defined, must be recorded on tax returns so as to clearly reflect income.

The government contends that the raw sugar involved in the Rionda transaction was not acquired for use in the ordinary course of SuCrest's business and that the sugar was thus not truly part of SuCrest's inventory.

. . . .

I told you that the defendants contended that SuCrest had title to the sugar purchased, that the Rionda transaction had economic [substance], that the title to the sugar purchased from Rionda had risk of loss with respect to the sugar and that the transaction had a business purpose.

I misstated. What I should have also told you is that they contend that the oral agreement to resell the sugar to Rionda was not binding on either Rionda or on SuCrest. That is the defendant's contention.

(1910), to apply in the case of a corrupt agreement "calculated to obstruct or impair" the given governmental department's function. A conspiracy is, after all, an agreement to engage in prohibited conduct. *United States v. Herrara*, *supra*, 584 F.2d at 1150. It is immaterial that conspirators disband or are interrupted before the goal is achieved. *See United States v. Rosner*, 485 F.2d 1213, 1228-29 (2d Cir. 1973), *cert. denied*, 417 U.S. 950 (1974); W. Lafave & A. Scott, *Criminal Law* 459 (1972). Recognizing that conspiracy-to-defraud prosecutions must be carefully scrutinized, *United States v. Rosenblatt*, 554 F.2d 36, 40 (2d Cir. 1977), here the indictment and proof withstand such scrutiny since the criminal agreement was sufficiently established. *United States v. Tarnopol*, *supra*, is distinguishable, because there the Government failed to prove that the conspirators intended to defraud the Internal Revenue Service, even though they had not kept accurate business records. Here the whole purpose of the sale and resale transaction in 1976 as well as in 1975 was to evade federal taxes. As for the argument that a taxpayer has a right of "self-correction," it is clearly inapplicable to these defendants since it was only when the fraud was detected by the auditors that the scheme was dropped. *See United States v. James*, 609 F.2d 36, 41-42 (2d Cir. 1979), *cert. denied*, 445 U.S. 905 (1980). Requested instructions to this effect were therefore properly disallowed. In other words, Rapaport and his company did not go through with the ultimate fraud not because they "saw the light," but because the light saw them.

Appellants do have support, in connection with the Count Three charge of conspiracy to defraud in 1976, for their claim that the applicable statute of limitations is five

rather than six years, and that 18 U.S.C. § 3282, the general five-year statute, is applicable rather than that portion of 26 U.S.C. § 6531(1), (8).[10] While 26 U.S.C. § 6531(8) expressly refers to 18 U.S.C. § 371, "where the object of the conspiracy is to attempt in any manner to evade or defeat any tax or the payment thereof," the argument is that this is not an offense "arising under" the Internal Revenue laws. Moreover, support is said to lie for the applicability of section 3282 in *Grunewald v. United States*, 353 U.S. 391, 396 & n.8 (1957); *United States v. Klein*, 247 F.2d 908 (2d Cir. 1957), *cert. denied*, 355 U.S. 924 (1958); and *United States v. Witt*, 215 F.2d 580 (2d Cir.), *cert. denied*, 348 U.S. 887 (1954). Each of these cases states that an indictment alleging conspiracy under section 371 is governed by the statute of limitations set forth in 18 U.S.C. § 3282. We agree, however, with *United States v. Lowder*, 492 F.2d 953, 955-56 (4th Cir.), *cert. denied*, 419 U.S. 1092 (1974), that it was simply pure oversight in *Grunewald*, *Klein*, and *Witt* that reference was not made to the six-year statute, § 6531(1)(8). *See also United States v. Fruehauf Corp.*, 577 F.2d 1038, 1070

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10 26 U.S.C. § 6531 provides in part:

> No person shall be prosecuted . . . for any of the various offenses arising under the internal revenue laws unless the indictment is found or the information instituted within 3 years next after the commission of the offense, except that the period of limitations shall be 6 years—
>
> (1) For offenses involving defrauding or attempting to defraud the United States or any agency thereof, whether by conspiracy or not and in any manner;
>
> . . . .
>
> (8) for offenses arising under Section 371 of Title 18 of the United States Code, where the object of the conspiracy is to attempt in any manner to evade or defeat any tax or the payment thereof.

1070 (6th Cir.), *cert. denied*, 439 U.S. 953 (1978). The error is understandable because section 3282 applies "[e]xcept as otherwise expressly provided by law," but the statute does not name the exceptive statutes and leaves the courts to search the United States Code for them, a search which did not lead to section 6531 in *Grunewald*, *Klein*, or *Witt*. In this respect this opinion has been circulated before filing to the active judges in this circuit, who have expressed no desire to hear the matter en banc.

SuCrest argues that its conviction on Count Four must be reversed because as a matter of law a corporation cannot be guilty of false declaration under 26 U.S.C. § 7206(1).[11] That section is described as a perjury statute and we are referred to the line of authority holding that corporations cannot commit perjury since a corporation cannot take an oath to tell the truth. *See* Note, 60 Harv. L. Rev. 283, 284 (1946); *United States v. John Kelso Co.*, 86 F. 304, 306 (N.D. Cal. 1898). And it is said that the Service has itself interpreted § 7206(1) and its predecessor, § 3809(A) of the Internal Revenue Code of 1939, so as not to apply to corporations, an interpretation which, while not controlling, is entitled to considerable weight. *E.g.*, *United States v. National Association of Security*

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11 26 U.S.C. § 7206(1) provides:

> Any person who—
>
> . . . [w]illfully makes and subscribes any return, statement, or other document, which contains or is verified by a written declaration that it is made under the penalties of perjury, and which he does not believe to be true and correct as to every material matter[,]
>
> . . .
>
> shall be guilty of a felony and, upon conviction thereof, shall be fined not more than $5,000, or imprisoned not more than 3 years, or both, together with the costs of prosecution.

Dealers, Inc., 422 U.S. 694, 719 (1975). But "person" is defined in the Internal Revenue Code to refer to corporations, 26 U.S.C. § 7701(A)(1), and § 7206(1) refers to "[a]ny person" willfully making and subscribing any return or other document verified by a written declaration that it is made under the penalties of perjury. Moreover, in terms of the statutory history the 1939 Code § 52 provided that "[e]very corporation subject to taxation under this Chapter shall *make* a return" to be sworn to by a principal executive and a principal financial officer. (Emphasis added.) Individuals were by the Revenue Act of 1942 § 145(C) made subject to perjury penalties for willfully making and subscribing false returns and the 1949 amendments to the Code adding § 3809(A) covered any person, a term including trusts, estates, partnerships, associations, companies, and corporations. *See* Sections 1426(f), 1532(i), 1607(k), 1805, 1931(b), 2733(i), 3228(2), 3238(a), 3797(a)(i) (1939), now collected in 26 U.S.C. § 7701(A). While a corporation has no independent state of mind, the acts of individuals on its behalf may be properly chargeable to it. *See United States v. Demauro*, 581 F.2d 50, 53 (2d Cir. 1978); *J.C.B. Super Markets, Inc. v. United States*, 530 F.2d 1119 (2d Cir. 1976). Other circuits have agreed under other analogous statutes. *United States v. Lange*, 528 F.2d 1280 (5th Cir. 1976) (18 U.S.C. § 1001); *United States v. Milton Marks Corp.*, 240 F.2d 838 (3d Cir. 1957) (18 U.S.C. § 287). Moreover, the Internal Revenue Service has in fact prosecuted other corporations for violations of § 7206(1). *See, e.g., United States v. Minnesota Mining & Manufacturing Co.*, 428 F. Supp. 707 (D. Minn. 1976) (indictment dismissed on other grounds), *aff'd*, 551 F.2d 1106 (8th Cir. 1977).

We have examined the other contentions of the appellants and find them without merit.[12]

Judgment affirmed.

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12 First, Rapaport's argument that his cross examination of witnesses was unfairly limited at best applies to the attempted re-cross of the witness Azarow who had been cross-examined for what amounts to 170 pages of final transript. Moreover, Judge Carter aptly noted that the pedantic concerns of counsel on re-cross were designed "to confuse and not clarify." Second, Rapaport's only tenable argument against the admission of SuCrest's 10-K Reports to the Securities and Exchange Commission is that it might have been misunderstood to apply to Rapaport as well as to SuCrest, an allegation mitigated by the court's repeated instruction to the jurors that these statements did not apply to Rapaport. Third, the government introduced evidence that SuCrest had not even recorded the receipt of the Rionda sugar in its files, but the records introduced covered two weeks and not the week that intervened between them. The prosecution explained the missing week by noting to the jury, after the defense was given an opportunity to introduce a witness or submit a reason for the failure of the records to cover the relevant week, that the files contained no report for the intervening week. The statement would by no means necessarily lead the jury to believe that the "defendants had suppressed or otherwise despoiled potentially critical evidence," and any risk that this would happen could have been cured by SuCrest through testimony or suggested explanations to be included in the prosecutor's statement. Finally, Judge Carter's instruction cautioning the jury that Rapaport's failure to testify could not be used to infer his guilt substantially mirrored the one approved by this court in *United States v. Lopez*, 584 F.2d 1175, 1179 (2d Cir. 1978), and we decline to disapprove it here.

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Docket Nos. 82-1128
82-1144

At a Stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse, in the City of New York, on the fifth day of January, one thousand nine hundred and eighty-three.

Present:

HON: JAMES L. OAKES
HON: RALPH K. WINTER, Circuit Judges
HON: CHARLES M. METZNER, District Judge of the Southern District of New York.

UNITED STATES OF AMERICA,

Appellee,

—v.—

INGREDIENT TECHNOLOGY CORPORATION, formerly known as SUCREST CORPORATION, and ROBERT M. RAPAPORT,

Appellants.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged and decreed that the judgments of said District Court be and it hereby is affirmed in accordance with the opinion of this court.

A. Daniel Fusaro, Clerk
/s/ ARTHUR HELLER
by Arthur Heller,
Deputy Clerk

STATUTES INVOLVED

18 U.S.C. § 371. Conspiracy to commit offense or to defraud United States

If two or more persons conspire either to commit any offense against the United States, or to defraud the United States, or any agency thereof in any manner or for any purpose, and one or more of such persons do any act to effect the object of the conspiracy, each shall be fined not more than $10,000 or imprisoned not more than five years, or both.

26 U.S.C. § 7201. Attempt to evade or defeat tax

Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than $10,000, or imprisoned not more than 5 years, or both, together with the costs of prosecution.

26 U.S.C. § 7206(2). Fraud and false statements

Any person who . . . [w]illfully aids or assists in, or procures, counsels, or advises the preparation or presentation under, or in connection with any matter arising under, the internal revenue laws, or a return, affidavit, claim, or other document, which is fraudulent or is false as to any material matter, whether or not such falsity or fraud is with the knowledge or consent of the person authorized or required to present such return, affidavit, claim, or document . . . . shall be guilty of a felony and, upon conviction thereof, shall be fined not more than $5,000, or imprisoned not more than three years, or both, together with the costs of prosecution.

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Nos. 82-1458 and 82-1526

In the Supreme Court of the United States

OCTOBER TERM, 1982

ROBERT M. RAPAPORT, PETITIONER

v.

UNITED STATES OF AMERICA

INGREDIENT TECHNOLOGY CORPORATION, ETC., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITIONS FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

REX E. LEE
Solicitor General

GLENN L. ARCHER, JR.
Assistant Attorney General

ROBERT E. LINDSAY
ALAN HECHTKOPF
Attorneys

Department of Justice
Washington, D.C. 20530
(202) 633-2217

QUESTIONS PRESENTED

1. Whether the court of appeals was correct in determining that the Internal Revenue Code and regulations thereunder gave the petitioners fair notice that the conduct for which they were convicted was illegal.

2. Whether the court of appeals used the correct standard in judging the issue of fair notice.

3. Whether the court of appeals was correct in upholding the district court's exclusion of expert testimony on the law applicable to petitioners' conduct and its refusal to instruct the jury that it could consider the asserted unclarity of the law in assessing the issue of willfulness.

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In the Supreme Court of the United States

OCTOBER TERM, 1982

No. 82-1458

ROBERT M. RAPAPORT, PETITIONER

v.

UNITED STATES OF AMERICA

No. 82-1526

INGREDIENT TECHNOLOGY CORPORATION, ETC., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITIONS FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The opinion of the court of appeals (Pet. App. A1-A26)[1] is reported at 698 F.2d 88.

JURISDICTION

The judgment of the court of appeals (Pet. App. A27-A28) was entered on January 5, 1983. The petition for a writ of certiorari in No. 82-1458 was filed on February 28, 1983. The petition in No. 82-1526 was filed on March 4, 1983. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

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[1] "Pet. App." refers to the appendix to the petition in No. 82-1458.

STATEMENT

After a jury trial in the United States District Court for the Southern District of New York, petitioners were convicted of conspiracy to evade SuCrest's (now Ingredient Technology Corporation) corporate federal income tax for fiscal 1975, in violation of 18 U.S.C. 371 (Count One), and conspiracy to defraud the United States by impeding the Department of the Treasury in the collection of revenue in connection with SuCrest's income tax for fiscal 1976, in violation of 18 U.S.C. 371 (Count Three). Petitioner Ingredient Technology Corporation ("SuCrest") was also convicted of subscribing to a false federal income tax return for fiscal 1975, in violation of 26 U.S.C. 7206(1) (Count Four). Petitioner Rapaport was also convicted of assisting SuCrest in the presentation of its false tax return for fiscal 1975, in violation of 26 U.S.C. 7206(2) (Count Five). (Pet. App. A1-A4). SuCrest was sentenced to fines aggregating $25,000 (82-1526 Pet. 10). Rapaport was fined $7500 and sentenced to concurrent terms of two years' imprisonment, all but six months suspended, to be followed by 18 months' probation.

1. The evidence at trial showed that from 1974 through 1976 SuCrest was a publicly traded company. The bulk of its business was conducted by its Sweetener Division, which refined raw sugar and sold it to users of refined sugar. SuCrest was not in the business of selling raw sugar or buying raw sugar for resale (Pet. App. A4). From 1974 through 1976 Rapaport was the president and chief executive officer of SuCrest. His approval was required for every purchase of raw sugar (*ibid.*).

During 1974, SuCrest changed its inventory accounting method to the LIFO ("last in, first out") method (Pet. App. A4).[2] As the end of its 1975 fiscal year (May

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[2] In 1974, the price of raw sugar began to fluctuate widely, and although SuCrest was making large gross profits as a result of price fluctuations upward, taxes on those profits and the escalating cost of raw sugar depleted its income. This motivated

31, 1975) approached, SuCrest's inventory was dramatically lower than it had been at the close of fiscal 1974 (Pet. App. A5).[3] To avoid having to compute its cost of goods sold on the basis of the lower-cost sugar remaining in its inventory (and therefore having to pay more income tax), SuCrest devised a series of sham transactions to increase its year-end inventory without incurring the expense and market risks of actually purchasing raw sugar.

At Rapaport's direction, SuCrest entered into an agreement with one of its suppliers, Czarnikow-Rionda Co. ("Rionda"). SuCrest was to buy from Rionda 50,000 long tons of raw sugar before the end of its 1975 fiscal year, then resell the sugar to Rionda after the close of the fiscal year. There was no risk to SuCrest, neither party would make a profit (apart from Rionda's "commission" of $84,000), and SuCrest would not take physical delivery of the sugar (Pet. App. A6-A7). To set different prices for the purchase and resale components of the transaction—and thereby create the appearance of an arms' length deal—the parties hinged the price to the market value of raw sugar on the futures exchange

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SuCrest to adopt the LIFO method (Pet. App. A4). Under LIFO, a taxpayer is permitted to assume that the raw materials he used to make finished goods during the year were the latest-acquired raw materials. In an inflationary period, therefore, the LIFO method produces a higher cost of goods sold, which in turn results in lower taxable income. By adopting LIFO and making year-end purchases of large amounts of high-priced raw sugar, SuCrest was able to report and carry forward in 1974 a loss of about $14.7 million. It otherwise would have had to report taxable income of $12.2 million (Pet. App. A4-A5).

[3] Although SuCrest had accumulated an unusually large inventory of raw sugar before the end of fiscal 1974, it used much of this inventory during 1975 and 1976 rather than purchase additional raw sugar, because prices and interest rates were increasing (Pet. App. A5).

(*id.* at A6). The gains and losses on sale and resale, however, would be offset by gains and losses on futures contracts to be purchased by the parties (*id.* at A6-A7).

Pursuant to the agreement, SuCrest and Rionda executed a written contract on April 18, 1975, covering Rionda's sale of raw sugar to SuCrest (Pet. App. A7). At Rapaport's direction, a written contract for resale was not to be prepared until after the end of SuCrest's fiscal year (Tr. 167-168, 849). Rapaport told Nicholas Ponticelli, a Sweetener Division raw sugar buyer, that a written resale contract would nullify the whole transaction (Tr. 1281). Rionda was concerned, however, about substantiating the oral agreement to resell. Jack Sexer, vice-president of SuCrest's Sweetener Division, therefore prepared a letter stating the terms of the resale, and he and a Rionda vice-president sealed it with sealing wax and placed it in the latter's safe. After the transaction was completed the two met and destroyed the letter (Pet. App. A7-A8).

In late May 1975, Rionda sent SuCrest a formal notice declaring title in SuCrest to the sugar, which was at sea on two ships. Just after the end of SuCrest's fiscal year, while the ships were still at sea, SuCrest "resold" the sugar to Rionda (Pet. App. A7). SuCrest included the sugar in its 1975 LIFO inventory calculations. During the period when SuCrest purportedly owned the sugar, however, Rionda declared title to the same sugar on one of the ships to another customer, pursuant to a contract made several weeks earlier (*ibid.*).

In carrying out the scheme, SuCrest and Rionda generated documents designed to give it an appearance of economic reality (Pet. App. A7). During SuCrest's 1975 audit these documents were shown to S.D. Leidesdorf & Company ("Leidesdorf"), SuCrest's auditors for many years. SuCrest personnel made false representations to the auditors and SuCrest's attorneys to conceal the fact that the resale of the sugar had been

prearranged.[4] As a result, SuCrest understated its 1975 operating profit by about $13.7 million (*id.* at A8).

SuCrest and Rionda agreed to a similar purchase and resale scheme for fiscal 1976. In August of 1975 the price of sugar, after declining steadily since April, turned upward. Rapaport decided to use the scheme with Rionda to lock in a high price for SuCrest's 1976 inventory calculations (Tr. 873-874). SuCrest and Rionda executed a written contract, dated August 5, 1975, for Rionda's sale of 60,000 long tons of sugar to SuCrest, with title to be declared to SuCrest in May of 1976 (Pet. App. A9). Throughout the rest of fiscal 1976, however, neither the sugar "purchase" nor a related $22 million futures position was reflected in SuCrest's internal operating records, since the sugar was never intended to be used in the ordinary course of business (Tr. 591, 1355-1360, 1485; G. Exh. 203A). In late May 1976, Rionda declared title to the sugar in SuCrest; during June, SuCrest "resold" the sugar to Rionda (Pet. App. A9).

The phony purchase was presented to the auditors in SuCrest's 1976 year-end calculations (Pet. App. A9). However, when Leidesdorf sought to confirm an oral report that the resale had been prearranged, SuCrest's management represented that the resale had not been planned before the end of the fiscal year (*id.* at A9-A10).[5]

On August 30, 1976, SuCrest's board of directors learned that the Rionda purchase and resale had been prearranged (Tr. 216-217). Afterward, Leidesdorf

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[4] During negotiation of the agreement Rapaport cautioned subordinates to keep the plans secret, lest the auditors disallow inclusion of the sugar in SuCrest's inventory (Tr. 154, 157, 226, 848).

[5] Rapaport was present at meetings when the president and vice-president of the Sweetener Division, without contradiction by Rapaport, gave false explanations for the resale (Pet. App. A9-A10).

expanded its audit procedures, the board retained the law firm of Milbank, Tweed, Hadley & McCloy ("Milbank, Tweed") to attempt to ascertain the facts, and the Securities and Exchange Commission took testimony (Tr. 234-235, 1604-1607, 1697). Both Milbank, Tweed and Leidesdorf concluded that the Rionda transactions had no substance and that the bogus purchases should not be included in the computation of SuCrest's cost of goods sold for fiscal 1975 and 1976 (Tr. 1607, 1700-1702; G. Exhs. 2, 418). In February 1977, SuCrest filed its fiscal 1976 tax return based on calculations which gave no recognition to the Rionda transactions.

2. The court of appeals affirmed the convictions (Pet. App. A27-A28). The court concluded that as a matter of law the Rionda sugar was not includable in SuCrest's LIFO inventory, since the sugar was never intended to be used in SuCrest's trade or business and was in the taxpayer's control only "about as long as the pea in the proverbial shell game is under the shell" (*id.* at A16). The court also rejected petitioners' contention that the applicable tax law was unclear, thereby negating the element of willfulness. The court pointed out that petitioners (*id.* at A18)

> surely * * * knew they were committing a wrongful act. * * * The resale component of the agreement was concealed. The auditors were lied to, as were the attorneys. The secret letter sealed with wax was hidden in a safe and then destroyed.

In addition, the court found no merit to petitioners' "more sophisticated argument" (Pet. App. A18) that the district court had erred in excluding testimony offered by two of petitioners' experts, and in deciding not to instruct the jury in the terms of the applicable Treasury Regulation. According to petitioners, the trial court's failure to do so thwarted their defense that they could not have formed a willful intent. The court found that "prior cases on willfulness consistently require fac-

tual evidence of the defendant's state of mind to negate willfulness" (*id.* at A19). In this case, by contrast, "there was no evidence that Rapaport or anyone else at SuCrest genuinely thought that what they were doing was lawful" *(ibid.)*. The court did not find that its holding conflicted with the decision of the Fifth Circuit in *United States* v. *Garber*, 607 F.2d 92 (1979) (en banc), since in that case the defendant presented the defense that she "'subjectively thought that proceeds from the sale * * * were not taxable'" (Pet. App. A19). In any event, the court noted that the Fifth Circuit had itself limited *Garber* in a subsequent case (*id.* at A20).

ARGUMENT

1. SuCrest contends (82-1526 Pet. 11-16) that its conviction was based on an unforeseeable interpretation of the Internal Revenue Code and regulations pertaining to inventories, depriving it of its right to fair notice. SuCrest argues (*id.* at 12-13) that it met every formal requirement of the Code and regulations, and that the court of appeals retroactively expanded criminal liability by "read[ing] into the statute a 'business purpose' requirement." The applicable law, however, was clear and well established.

Section 1.471-1 of the Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.) provides that inventories are necessary "in every case in which the production, purchase, or sale of merchandise is an *income-producing* factor" (emphasis added), and that raw materials are only to be included in inventory if they have been acquired for sale or will physically become a part of merchandise intended for sale. Over 50 years ago, the Second Circuit held that under this regulation "sale" means a sale for profit. *Francisco Sugar Co.* v. *Commissioner*, 47 F.2d 555, 557 (1931) (L. Hand, J.). See also *Grant Oil Tool Co.* v. *United States*, 381 F.2d 389, 398 (Ct. Cl. 1967); *Pierce-Arrow Motor Car Co.* v. *United States*, 9 F. Supp. 577,

584-585 (Ct. Cl. 1935). As the court of appeals recognized (Pet. App. A14), SuCrest never intended to refine the Rionda sugar, was not in the business of buying and reselling raw sugar, and did not enter into the agreements with Rionda in order to produce income. The transactions affected no beneficial interest other than the reduction of taxes. Thus, SuCrest did not meet all the requirements of the regulation for inclusion of the sugar in its inventory, and there was nothing new or unforeseeable in the court of appeals so holding.[6]

The holding of the court of appeals was also compelled by the well-settled principle that the substance of a transaction prevails over its form in matters of taxation. *E.g.*, *Knetsch* v. *United States*, 364 U.S. 361 (1960); *Commissioner* v. *Court Holding Co.*, 324 U.S. 331, 334 (1945); *Griffiths* v. *Commissioner*, 308 U.S. 355, 357-358 (1939); *Higgins* v. *Smith*, 308 U.S. 473 (1940); *Gregory* v. *Helvering*, 293 U.S. 465, 468-469 (1935). That principle is applicable unless an examination of the statute and its purpose reveals that form was intended to be determinative. *Knetsch*, *supra*, 364 U.S. at 367; *Glazer* v. *Commissioner*, 44 T.C. 541, 545-546 (1965). SuCrest points to nothing showing such an intent with respect to the inventory rules.[7] Further,

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[6] *William Powell Co.* v. *United States*, 524 F. Supp. 841 (S.D. Ohio 1981), which SuCrest cites (82-1526 Pet. 12 n.*), does not support the proposition that merchandise acquired without a business purpose may be included in a LIFO inventory. The court, construing 26 U.S.C. 472(c), held only that that section did not condition use of the LIFO method on the existence of a business purpose. 524 F. Supp. at 845-846. The court did not address the requirements for inclusion of goods in inventory.

[7] SuCrest advances the notion that because LIFO is a "theoretical method of accounting for inventory * * *, the purpose of the statute would not be served by reading into it a requirement of 'substance over form' or 'business purpose'" (82-1526 Pet. 14). But while LIFO uses a fictitious assumption about the flow

well before petitioners committed the offenses in this case, the Tax Court had held that the economic realities of transactions control in the computation of the costs of goods purchased for sale. *Brooks-Massey Dodge, Inc.* v. *Commissioner*, 60 T.C. 884, 891-892 (1973); *Estate of Nottingham*, 25 T.C.M. (P-H) ¶ 56,281 (1956). See also Rev. Rul. 60-243, 1960-2 Cum. Bull. 160. In light of these precedents, the insistence on "substance over form" could hardly be characterized as unforeseeable.

SuCrest's reliance (82-1526 Pet. 15) on *Bouie* v. *City of Columbia*, 378 U.S. 347 (1964), *Douglas* v. *Buder*, 412 U.S. 430 (1973), and *Marks* v. *United States*, 430 U.S. 188 (1977), is entirely misplaced. Unlike those cases, where the statute or other applicable law gave no warning that the charged act was an offense, the interpretation of the inventory rules here is clearly compelled by the language of Section 1.471-1 of the Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.), which correlates the use of inventories with the production of income. SuCrest cites no judicial or administrative authority adopting a contrary interpretation of the inventory rules, and there is thus nothing to support a conclusion that the interpretation adopted by the courts below was unforeseeable.

The absence of conflicting authorities also distinguishes this case from *James* v. *United States*, 366 U.S. 213 (1961),[8] and *United States* v. *Critzer*, 498

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of goods and Congress has approved that method, it does not follow that the underlying transactions that are being accounted for—the purchases and sales of goods—can be equally fictitious.

[8] In *James*, the defendant had been convicted of attempted income tax evasion for failing to report embezzled funds. This Court held such funds taxable, overruling a prior decision, *Commissioner* v. *Wilcox*, 327 U.S. 404 (1946), in which it had held to the contrary. The vitality of *Wilcox* had been undermined earlier by *Rutkin* v. *United States*, 343 U.S. 130 (1952). Despite the holding as to the taxability of embezzled funds in *James*, this Court reversed the conviction. In a plurality opinion, three Justices concluded that willfulness could not be prov-

F.2d 1160, 1162-1164 (4th Cir. 1974),[9] on which SuCrest relies (82-1526 Pet. 16-17). Unlike those cases, where the question of taxability was uncertain because of conflicting court decisions or government positions, there was no uncertainty here over the requirements to be met for inclusion of goods in inventory.

Contrary to SuCrest's assertion (82-1526 Pet. 14-15), the issuance of Rev. Rul. 79-188, 1979-1 Cum. Bull. 191, in 1979 does not prove that the law was unclear in 1975 and 1976, when the charged offenses occurred. In that ruling, the Internal Revenue Service held that property not intended by the taxpayer to be used in business could not be included in inventory for the purpose of avoiding invasion of a LIFO base. However, as the court of appeals pointed out (Pet. App. A17 n.8),

> the ruling goes to different facts, since under it the purchase and resale were not prearranged, the prices were not structured to eliminate the possibility of profit or loss on the resale, and there were no indicia of concealment. Moreover, as Revenue Ruling 79-188 itself points out, "the purpose for which raw material is purchased is a major factor whether such material is inventoriable by the taxpayer," and has been since *Latimer-Looney Chevrolet, Inc. v. Commissioner*, 19 T.C. 120 (1952) *acq'd in* 1953-1 C.B. 5, which the Ruling cites for that proposition.[10]

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en so long as the tax statute contained the gloss placed on it by *Wilcox*. 366 U.S. at 221-222.

[9] In *Critzer*, "co-ordinate branches of the United States Government" (498 F.2d at 1162) had reached directly opposing conclusions as to the taxability of income the defendant had failed to report. The Fourth Circuit concluded that in light of this circumstance, as a matter of law, the requisite intent to evade and defeat income taxes was missing. *Ibid.*

[10] Even before *Latimer-Looney*, the purpose for which materials were purchased was held to be a controlling factor in determining whether the materials were inventoriable. See, *e.g.*, *Francisco Sugar Co.* v. *Commissioner*, *supra*, 47 F.2d at 557.

Thus the Ruling did not signify any lack of clarity in the law.

Even if the law had been open to good faith differences of opinion, this case would present no notice problems under the Due Process Clause, since the crimes of which petitioners were convicted required specific intent to commit prohibited acts. Such a scienter requirement "relieve[s] the statute of the objection that it punishes without warning an offense of which the accused was unaware." *Screws* v. *United States*, 325 U.S. 91, 102 (1945); see also *Boyce Motor Lines, Inc.* v. *United States*, 342 U.S. 337, 342 (1952); *United States* v. *Ragen*, 314 U.S. 513, 524 (1942); *Gorin* v. *United States*, 312 U.S. 19, 26-28 (1941); *Hygrade Provision Co.* v. *Sherman*, 266 U.S. 497, 502-503 (1925). As this Court said in *Ragen*, *supra*, 314 U.S. at 524: "A mind intent upon willful evasion is inconsistent with surprised innocence." In this case, the evidence demonstrates that petitioners were not surprised. As the court of appeals determined (Pet. App. A18):

> Here surely the defendants knew they were committing a wrongful act. * * * The resale component of the agreement was concealed. The auditors were lied to, as were the attorneys. The secret letter sealed with wax was hidden in a safe and then destroyed. * * * Willful intent was a question of fact decided by the jury at trial contrary to the defendants.

2. SuCrest also contends (82-1526 Pet. 16-20) that the court of appeals improperly used a subjective test (petitioners' actual knowledge and intent) rather than an objective test (whether a person of ordinary intelligence would have had fair notice) in judging SuCrest's claim that it was deprived of fair notice. But the court of appeals in fact concluded that the objective test had been satisfied. The court agreed (Pet. App. A17) that "a criminal statute must * * * be sufficiently definite as to 'give a person of ordinary intelligence fair notice that his contemplated conduct is forbidden.' *United States*

v. Harris, 347 U.S. 612, 617 (1954)." Nothing in its opinion suggests a belief that the law was uncertain, but could be applied against petitioners simply because of their subjective state of mind. Rather, in rejecting petitioners' argument that Revenue Ruling 79-188 implied uncertainty, the court indicated the contrary (Pet. App. A17 n.8): "The issuance of the LIFO Revenue Ruling in 1979 * * * by no means signifies a lack of clarity in the law at the time the SuCrest-Rionda transaction was entered into in 1975." The court's focus on petitioners' actual knowledge and intent (*id.* at 18a) simply emphasized that this is not a case where an unknowing party has been trapped by a law of which he was justifiably unaware.

3. Petitioner Rapaport contends (82-1458 Pet. 12-15) that the tax law applicable to the SuCrest-Rionda transactions was uncertain, and that the trial court erred in refusing to instruct the jury that it could consider this uncertainty in deciding about willfulness. Rapaport further contends (*id.* at 15-16) that the trial court erred in excluding expert testimony on the applicable tax law. He contends that the court of appeals' decision rejecting these claims conflicts with *United*

States v. *Garber*, 607 F.2d 92 (5th Cir. 1979).[11] These contentions are without merit.

Garber was convicted of income tax evasion for failure to report income from the sale of her blood plasma. The en banc Fifth Circuit reversed (four judges dissenting) and ordered a new trial. The majority held that in light of the uncertainty in the applicable law about the taxability of the proceeds from the sale of one's blood plasma, the trial court had erred in excluding expert testimony as to the tax law and in refusing to instruct the jury that a reasonable misconception of the tax law on defendant's part would negate the necessary criminal intent.

While we believe that *Garber* was wrongly decided, the court of appeals in any event correctly held (Pet. App. A18-A20) that *Garber* is inapposite here.[12]

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[11] Rapaport also argues (82-1458 Pet. 15-16, 18-19) that the Ninth Circuit followed *Garber* in *United States* v. *Clardy*, 612 F.2d 1139, 1153 (1980), and that the decision in this case therefore conflicts with *Clardy* as well. The court in *Clardy* stated that the government's expert testimony about the impropriety of an interest deduction was relevant to the issue of willfulness, since the defense theory was that there was a good faith dispute about the interpretation of the tax laws. The court did not hold, however, that exclusion of expert testimony on the law would be error. Indeed, the court stated that the trial court exercises broad discretion in determining whether to admit or exclude expert testimony, and that its determination must be sustained unless manifestly erroneous (612 F.2d at 1153). There is thus no reason to believe that the Ninth Circuit would follow *Garber* in a case such as this.

Rapaport also notes (82-1458 Pet. 12 n.12) that in *United States* v. *Baskes*, 687 F.2d 165, 168-169 (1981), the Seventh Circuit mentioned that a tax attorney testified as an expert witness for the defense. However, as Rapaport acknowledges, the court cited neither *Garber* nor *Clardy*. Nor did the court state whether exclusion of expert testimony on the law would have been error.

[12] In addition to distinguishing *Garber*, the Second Circuit declined to follow it to the extent it was inconsistent with the Second Circuit's decisions in *United States* v. *Bronston*, 658

Garber involved a tax question that "was completely novel and unsettled by any clearly relevant precedent." 607 F.2d at 100. Here, by contrast, there was ample precedent supporting the lower courts' interpretation of the applicable tax law.[13] Moreover, in *Garber* "[t]he de-

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F.2d 920, 930 (1981), cert. denied, 456 U.S. 915 (1982), and *Marx & Co.* v. *Diners' Club, Inc.*, 550 F.2d 505, 509-510, cert. denied, 434 U.S. 861 (1977). In those cases, the Second Circuit adhered to the principle that expert testimony on the law is generally inadmissible. The Second Circuit's view is in accord with the weight of authority. *Cooley* v. *United States*, 501 F.2d 1249, 1254 (9th Cir. 1974), cert. denied, 419 U.S. 1123 (1975); *Loeb* v. *Hammond*, 407 F.2d 779, 781 (7th Cir. 1969); *White* v. *United States*, 216 F.2d 1, 5 (5th Cir. 1954); *United States* v. *Caserta*, 199 F.2d 905, 909 (3d Cir. 1952); *Lisansky* v. *United States*, 31 F.2d 846, 851 (4th Cir.), cert. denied, 279 U.S. 873 (1929); see also 7 J. Wigmore, *Wigmore on Evidence* § 1952 (Chadbourn rev. 1978).

The *Garber* majority held the opinion evidence admissible on the theory that a defendant is "entitled to wide latitude in the introduction of evidence tending to show lack of intent." 607 F.2d at 99. But the cases cited for that principle do not support the proposition that evidence unrelated to a defendant's actual intent should be admitted. In fact, the cases are to the contrary. See 607 F.2d at 106-107 (Ainsworth, J., dissenting). Thus, under the weight of authority, expert testimony misconstruing the law is not admissible unless the defendant has actually relied upon it. Here, of course, there was no evidence that the defendants had done so.

[13] Petitioner Rapaport contends (82-1458 Pet. 9, 13) that the trial court acknowledged that the tax law was unclear in 1975 and 1976. The court stated: "You might be entirely correct about that if this were a civil proceeding, but it is not. *The fact that it was not in writing and the effect of this does not, it seems to me, negate the issue of whether or not there has been a violation of the criminal law.* In the civil area you might be correct" (Tr. 1815; emphasis added). In his petition, Rapaport omits the emphasized language, which helps to put the court's statement in perspective. The court made the statement (during argument on a motion for acquittal) in response to a technical argument that SuCrest was permitted to include the Rionda sugar in its inventory because the agreement to resell the sugar was unenforceable under the New York statute of frauds (Tr.

fendant testified that she subjectively thought that proceeds from the sale of part of her body were not taxable." 607 F.2d at 99. Here, as the court of appeals observed (Pet. App. A19), there was no evidence that Rapaport or anyone else at SuCrest genuinely thought that inclusion of the Rionda sugar in inventory was proper.[14]

Garber plainly turned on the evidence of the defendant's subjective belief.[15] The court there found the excluded expert testimony relevant to buttress Garber's explanation of her failure to report the income from the sale of her blood plasma: "By disallowing Nall's testimony that a recognized theory of tax law supports Garber's feelings, the court deprived the defendant of evidence showing her state of mind to be reasonable." 607 F.2d at 99. As to the refused instruction, the ma-

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1814-1815). The court obviously recognized that formalities as to ordinary commercial contracts have no place where a criminal conspiracy is involved. The court did not indicate that it believed the tax law to be uncertain. Indeed, during a later colloquy concerning instructions, it expressly asserted the contrary (Tr. 1971).

[14] Rapaport suggests (82-1458 Pet. 9, 17) that his good-faith belief in the propriety of the transactions is demonstrated by the testimony of Charles Azarow, president of SuCrest's Sweetener Division. According to Rapaport, Azarow "testified that * * * 'Mr. Rapaport continued to believe that that situation was an appropriate one despite the acknowledgement of the oral agreement'" (*id.* at 9). In fact, the statement quoted by petitioner was simply read to Azarow on cross-examination (Tr. 327-328, 430). Azarow acknowledged having made the statement, though he did not reaffirm its truth. The fact that the petitioner can find no better support in the record for his claim of good faith is of itself eloquent testimony to the accuracy of the court of appeals' observation.

[15] Contrary to Rapaport's assertion (82-1458 Pet. 18), *Garber* did not hold that a subjective belief as to the legality of a defendant's conduct is irrelevant to willfulness where the law is ambiguous. The majority rather held that the ambiguity was relevant to an assessment of the defendant's subjective state of mind. 607 F.2d at 99.

jority stated: "The court erred by refusing to instruct the jury that a reasonable misconception of the tax law on her part would negate the necessary intent" (*ibid.*).[16]

On the other hand, where there is no evidence that a defendant believed in good faith that his conduct was proper,[17] there is no factual basis for an instruction on a reasonable misconception of the law, and expert evidence as to the state of the law lacks even the dubious probative value found in *Garber*. Such evidence cannot, by itself, reasonably give rise to an inference that a defendant lacked criminal intent, since the defendant may fully understand the law notwithstanding its alleged ambiguities. Moreover, a rule requiring the admission of such evidence in any case where a defendant disputes the interpretation of the tax laws would inevitably invite juries to form their own opinions about the applicable law. Thus if it is ever admissible—a proposition which we do not concede—expert evidence on the law can, at best, be relevant only to buttress a defendant's claimed belief that his conduct was lawful. Accordingly, even if *Garber* was correctly decided, the Second Circuit properly read the decision as limited to situations in which a defendant has presented evidence of a subjective belief in the lawfulness of his conduct, and

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[16] In this case petitioners requested that the jury be instructed on the actual language of the governing tax law at the time of the Rionda transactions, and that the jury be told that it could consider the relative clarity of the tax law in determining willfulness. Such an instruction was not considered in *Garber*. Clearly, the requested instruction would have invaded the province of the court as to the issue of the clarity of the law, and would have invited the jury to make legal assessments that were beyond its competence.

[17] Contrary to Rapaport's suggestion (82-1458 Pet. 17-18), the court of appeals did not hold that under its reading of *Garber* a defendant had to testify in order to get an instruction on the state of the law. It simply noted a lack of evidence of *any* kind showing that Rapaport had an innocent state of mind (Pet. App. A19).

there is no assurance that the Fifth Circuit would have decided the present case any differently from the Second Circuit.[18]

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

REX E. LEE
Solicitor General
GLENN L. ARCHER, JR.
Assistant Attorney General
ROBERT E. LINDSAY
ALAN HECHTKOPF
Attorneys

MAY 1983

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[18] Indeed, the Fifth Circuit has indicated that *Garber* should be read narrowly. See *United States* v. *Herzog*, 632 F.2d 469, 473 (1980), rehearing and rehearing en banc denied, 636 F.2d 315 (1981). There, the defendant was convicted of filing withholding forms in which he falsely represented that he was exempt from taxes. He testified that he filed the forms claiming a total exemption because he believed that his wages were not taxable. He also testified that he found the Internal Revenue Code contradictory and confusing. 632 F.2d at 471. Herzog attempted to introduce expert testimony on the complexity of the tax law, but the testimony was excluded. A majority of the *Herzog* panel concluded that *Garber* was inapplicable and that the evidence was properly excluded. 632 F.2d at 473. The court found that the defendant was not accused of failing to report something that he received as income, as was Garber; rather he was "charged with filing false exemption forms, and no amount of expert testimony could help him in this regard" *(ibid.)*.

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IN THE

Supreme Court of the United States

OCTOBER TERM 1982

ROBERT M. RAPAPORT,

Petitioner,

—v.—

UNITED STATES OF AMERICA,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF IN SUPPORT OF PETITION

FREDERICK T. DAVIS

Attorney for Robert M. Rapaport
30 Rockefeller Plaza
New York, New York 10112
(212) 541-4000

Of Counsel:

Leslie C. Levin

Patterson, Belknap, Webb & Tyler
30 Rockefeller Plaza
New York, New York 10112
(212) 541-4000

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Robert M. Rapaport respectfully submits this reply brief in further support of his petition for a writ of certiorari to review the opinion and judgment of the United States Court of Appeals for the Second Circuit entered on January 5, 1983.

ARGUMENT

In its brief in opposition to the petitions for writs of certiorari,[1] the Government relies almost exclusively on the

1 A petition for certiorari was submitted by co-defendant Ingredient Technology Corporation, captioned *Ingredient Technology Corporation* v. *United States of America*, No. 82-1526, on which Mr. Rapaport also relies. Citations to that petition are in the form "ITC Pet"; citations to Mr. Rapaport's petition are in the form "R. Pet."

decision of the Court of Appeals and declines to address the issues raised in the petitions for certiorari. The Government takes this *ipse dixit* approach for an obvious reason: it has no adequate response to petitioners' arguments.[2]

As set forth in the petitions for certiorari, the Court of Appeals reached an illogical result in this action because it refused to permit evidence on the issue of intent—whether there was an intentional violation of a *known* legal duty—notwithstanding its acknowledgment that this was the applicable standard. It also incorrectly used a subjective test rather than an objective test in determining whether defendants had fair notice of the law. *No court has ever adopted the logic of the panel in this case; every decision which has addressed the issue has ruled differently.* The decision of the Court of Appeals undeniably created a conflict among the circuits, which the Second Circuit recognized and which only an Alice-in-Wonderland approach to the law could distinguish away.

A. The Government does not deny that there has *never* before been a criminal or civil determination of the propriety of including in LIFO inventory a commodity purchased subject to a resale understanding.[3] Nor does it dispute that the stand-

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2 Apparently for this reason, the Government also takes unusual liberties with the record. For example, it asserts (G. Br. 5, n.4) that "[d]uring the negotiation of the agreement Rapaport cautioned subordinates to keep the plans secret, lest the auditors disallow inclusion of the sugar in SuCrest's inventory (Tr. 154, 157, 226, 848)." Only one of the cited pages refers to Rapaport cautioning secrecy, and his comment related to talking to others in the sugar trade (Tr. 848). Moreover, the Government's witness testified that secrecy in sugar transactions was an industry practice to avoid loss of price advantage (Tr. 359, 981).

3 In this regard the court's observation in *AFL-CIO* v. *Federal Election Comm'n*, 628 F.2d 97 (D.C. Cir.), *cert. denied*, 449 U.S. 982 (1980) is particularly apt:

> We think it is obvious that in construction of any penal statute of which willfulness is an element, it is possible for the meaning of the statute to be clear to the mind of a trained judge, and still be less than clear enough to support a finding of willful violation. This is certainly so where, as here, the question . . . was hitherto untested by any sort of tribunal, and there was no regulation or even press release by the Commission, so far as cited to us." *Id.* at 101.

ard in criminal tax cases is that a defendant may not be convicted unless he has violated a "*known* legal duty." *United States* v. *Pomponio*, 429 U.S. 10, 12 (1976) (emphasis added). Although the Government may prefer a different standard, even it cannot deny that the defendants could not have "known" that the Rionda transactions could not be included in inventory if the tax law on this point was undeveloped or unclear.

Nevertheless, as set forth in Rapaport's petition for certiorari, defendants were deprived of the opportunity to put in proof on this critical issue. The Fifth Circuit, sitting *en banc*, has concluded that it is reversible error to refuse to permit the defendant to demonstrate that the tax law was unclear, thereby negating the necessary intent to violate the law. In *United States* v. *Garber*, 607 F.2d 92 (5th Cir. 1979), as here, "[i]n effect, the court adopted the government's position that a tax was owing as a matter of law." *Id.* at 99. In its decision reversing the trial court the Fifth Circuit noted "[i]n a case such as this where the element of willfulness is critical to the defense, the defendant is entitled to wide latitude in the introduction of evidence tending to show lack of intent." *Id.*

The Government weakly attempts to distinguish the *Garber* case by arguing that the substantive tax law is clearer in the case presented here. Yet as demonstrated in Ingredient Technology Corporation's petition for certiorari, the Government's interpretation of the substantive tax law could not have been "known" during 1975 or 1976 by a tax expert, much less by a layman (ITC Pet. 11-16). The Government does not deny that Rapaport, a businessman with no legal training, devised a plan to protect the company's LIFO base that was virtually identical to commodity tax straddles, used by thousands of investors in the mid-1970's with the tacit (and often explicit) acquiescence of the IRS (R. Pet. 6-7). To conclude that he violated a "known" legal duty flies in the face of the tax law at the time and the evidence in this case.

Indeed, the Government studiously ignores the fact that *every* party who addressed the issue believed the substantive tax law was unclear or favored the taxpayer. *The trial court,*

responding to the argument that the Rionda transactions were permissible, stated "[y]ou might be entirely correct about that if this were a civil proceeding, but is not . . . . [i]n the civil area you might be correct" (Tr. 1815).[4] *The law firm of Milbank, Tweed, Hadley & McCloy* noted in a 1977 report that the legality of the transactions was "not free from dispute, and reasonable persons expert in the fields of tax law and accountancy may differ in their interpretation and conclusions" (R. Pet. 13). Furthermore, *two unchallenged experts in the area of federal income taxation*—including an attorney who was formerly in charge of tax cases in the Solicitor General's office—concluded that the Rionda transactions were permissible under the Code (Tr. 1874-1900, 1909-22), or at a minimum, that the Code and regulations thereunder did not provide the defendants with a basis for predicting that the courts would later reach a different conclusion (Tr. 1916-18).

Thus, as a matter of law, defendants could not have violated a "known legal duty" because the lack of clarity of the law prevented the duty from being known. *See James* v. *United States*, 366 U.S. 213, 221 (1961).

B. Moreover, the Government also ignores the fact that even the Second Circuit panel could not bring itself to state or suggest that the substantive tax law was clear or could be "known."[5] Rather, it observed that "surely the defendants

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4 The Government's suggestion that the full quotation changes the meaning or import of the trial court's observation is fundamentally misleading. The full quote simply reflects that the trial court was addressing defendants' argument that the absence of a written resale agreement negated any violation of the criminal law because absent a writing, SuCrest was not obligated to resell the sugar. Far from being a response to a "technical" argument, it went to the heart of the issue here. Indeed, the Government's own witness gave testimony that Rapaport believed that the transaction was allowable so long as no written agreement existed (Tr. 326-28).

5 Although the Government attempts to argue that the Court of Appeals applied an objective standard, it points only to the Court of Appeals' observation that the issuance of Revenue Ruling 79-188 "by no means signifies a lack of clarity in the law" (G. Br. 12). Neither in that observation nor in any other portion of the opinion did the panel hold that the law was, in fact, clear.

knew they were committing a wrongful act" (A-18) by looking to evidence—most of which was not even arguably attributable to Rapaport (R. Pet. 5; 17 n.14)—and inferring from it that the defendants subjectively knew that they were violating some duty. In short, the literally unprecedented rule enunciated by the panel is that the defendant need not have violated a "known legal duty" if he subjectively *thought* he was committing such a violation.

In addition, the panel's conclusion that the defendants must demonstrate that they relied on the uncertainty of the law is at odds with this Court's decision in *James* v. *United States*, *supra*,[6] and directly conflicts with the *en banc* decision in *United States* v. *Garber*, *supra*, 607 F.2d 92, in which the court was emphatic that subjective belief about the legality of the conduct is irrelevant where the law is vague and ambiguous. Notwithstanding the Government's attempt to portray the *Garber* decision as one that hinged on subjective intent, the Fifth Circuit stated with unmistakable clarity that its conclusion did not "depend on whether the defendant actually knew of the conflict." 607 F.2d at 98. *See also United States* v. *Critzer*, 498 F.2d 1160, 1162 (4th Cir. 1974).

The Government's contention that *Garber* is distinguishable from the instant case on the ground that there was proof in *Garber* of reliance on the uncertain law is both incorrect and a thinly veiled argument that the defendant must take the stand in order to present his defense of lack of specific intent to violate the law. As set forth in Mr. Rapaport's petition, sworn testimony from the Government's witness revealed that Mr. Rapaport believed that an oral resale agreement did not negate the accounting procedures used (Tr. 326-28).[7] Moreover, it

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6 In *James*, the majority reversed the conviction and remanded the case with directions to dismiss the indictment, declining to follow the suggestion of two dissenting Justices who argued that a remand was necessary for a jury to determine the factual question of whether the defendant actually relied on the uncertain law. 366 U.S. at 248.

7 Notwithstanding the Government's attempt to downplay this evidence, the testimony was neither changed nor recanted during re-direct examination by the Government (Tr. 430-31).

appears from the decision that the proof in *Garber, apart from defendant's own testimony*, "showed that those with whom she dealt advised her that they thought the proceeds were taxable." 607 F.2d at 100.

C. The Government's attempt to create the impression that there is no conflict among the Circuits represents either simple arrogance or wishful thinking. The Court of Appeals "agree[d] with the *Garber* dissent," and "declined to follow" the Fifth Circuit (A-19—A-20). Moreover, the *Garber* decision is simply not distinguishable from the case presented here—for reasons already demonstrated in the original petition (R. Pet. 12-16), and to which the Government does not deign to reply.

The Government has not denied and cannot deny that the issue of the admissibility of expert testimony in tax cases relating to the subject of wilfulness is an important one which is appearing with increasing frequency. Although the Government feebly attempts to distinguish *United States* v. *Baskes*, 687 F.2d 165 (7th Cir. 1981) and *United States* v. *Clardy*, 612 F.2d 1139 (9th Cir. 1980), on the ground that those courts did not consider the issue of whether it was error to exclude expert testimony, it cannot escape the law in the Fifth Circuit, and the clear statements of the Seventh and Ninth Circuits, that the courts will admit such expert testimony in tax cases as bearing on the issue of whether the duty could be "known."

CONCLUSION

The Government's arrogant attempt to salvage a conviction, despite the glaring gaps in logic and precedent that are obvious in the panel's opinion, cannot obscure the fundamental reasons why this case should be reviewed:

1. Other than this panel, no court in any jurisdiction or at any level of the federal system has *ever* adopted a subjective test for determining whether the substantive tax law was sufficiently unambiguous to form the basis of a criminal prosecution. Every court addressing the issue has rejected a subjective test.

2. Other than this panel, no court has *ever* upheld the exclusion of competent proof that the substantive tax law was unclear. Every court addressing the issue has rejected the logic of the panel's opinion.

There is an irreparable conflict among the circuits on an issue of increasingly frequent significance. This Court should review the case.

Dated: June 13, 1983

Respectfully submitted,

FREDERICK T. DAVIS

Attorney for Robert M. Rapaport
30 Rockefeller Plaza
New York, New York 10112
(212) 541-4000

Of Counsel:

Leslie C. Levin

Patterson, Belknap, Webb & Tyler
30 Rockefeller Plaza
New York, New York 10112
(212) 541-4000